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SUBMISSION

to

THE RESTRICTIVE TRADE PRACTICES COMMISSION

ON

THE STATE OF COMPETITION

IN

THE CANADIAN PETROLEUM INDUSTRY

INTERNATIONAL LINKAGES —

CANADA AND THE WORLD PETROLEUM MARKET

1958 — 1982

TEXACO CANADA INC.

VOLUME A



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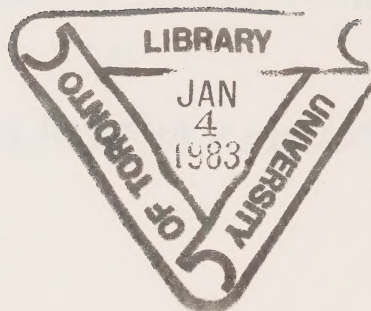
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VOLUME A



TEXACO CANADA INTERNATIONAL SUBMISSION VOLUME A

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PREFACE

OPENING STATEMENT OF TEXACO CANADA INC.

International Sector

In Volumes I and III of *The State of Competition in the Canadian Petroleum Industry* (the “Green Books”), the Director of Investigation and Research (the “Director”) describes relations between Texaco Canada Inc. and its majority shareholder and affiliates in the pre-1973 period. The Director’s report concluded with two recommendations that were reiterated by his counsel, in his opening submission before this Commission.

They were:

Recommendation #1:

legislation be enacted to prohibit the payment of artificially high transfer prices by Canadian companies to foreign parent or affiliated companies where such practices adversely affect the Canadian consumer;

Recommendation #2:

legislation be enacted to grant the appropriate authorities the necessary power to obtain information that is stored abroad by the parent or affiliated company of a Canadian company, where that information relates to activities affecting competition in Canada.

Counsel for the Director tendered an opening statement under the heading “International Linkages — Canada and the World Petroleum Market”.

At page 3 of that statement, the Director, by his counsel, indicated that evidence would be led to prove that Canadian refiners paid prices for crude oil in excess of fair market value during the period of time under review in the Green Books. The Director indicated an intention to call evidence to determine whether such practices continued in the post-1973 period.

The Green Books contain allegations of tax fraud, fraud on minority shareholders and international conspiracy that were not supported by evidence tendered at the Inquiry. Considerable time and money would be wasted if Texaco Canada embarked on the task of refuting every allegation, misconception and innuendo critical of Texaco Canada and its associated companies that appears in the Green Books.

In preparing its submission on this sector of the Inquiry, Texaco Canada is motivated by the following principles:

It is important that the Inquiry focus on competition issues and that a report be prepared and presented in a timely way.

The Director made no real effort to prove by credible evidence most of the scandalous allegations of misconduct presented in the Green Books.

Imperial Oil Limited, in a carefully researched and extensive analysis of the International sector, addressed the realities of the international crude oil market and prepared and presented panels of experienced and knowledgeable witnesses to be cross-examined on all aspects of its presentation. Texaco Canada will not duplicate that effort. No useful purpose would be served thereby.

The Issue

It is respectfully submitted that the allegations and concerns expressed in the Green Books and by the Director's counsel concerning the International sector can raise only one competition question:

Were Canadian refiners charged prices for crude oil by majority shareholders that were in excess of fair market value, with the result that competition in the sale of petroleum products was affected and retail prices were artificially high?

For a competition issue to be presented the following elements must co-exist:

Prices paid for long term contract crude oil must be artificially high, that is, above fair market value and above what was available to a Canadian refinery free to purchase on the open market under similar terms.

Crude oil delivered to Canadian refineries must, in large measure, be coming from sources substantially controlled by their international parent.

Artificially high prices must be charged by a significant number of crude oil suppliers representing the source of a substantial percentage of crude oil refined in Canada.

Such pricing practices would have to be held together by an international conspiracy.

Comments on the Director's Approach

The Director's staff apparently misunderstood the magnitude of the petroleum industry, the process of corporate decision making and the social conscience of Canadian businessmen. The reader is frequently left with the impression that the Director launched his "study" with a series of anti-industry allegations and desperately sifted through thousands of pieces of information, in or out of context, to justify his conclusions. The "study" gives no indication of an objective search for truth. Nowhere does one find evidence of an inquiry into the benefits to Canada from the investments, risks, initiatives and foresight of the leaders of the petroleum industry. Who provided the capital and took the risks when financial feasibility was uncertain? Did significant benefits come to Canadians as a result of industry activities?

Texaco Canada has already urged the Director to withdraw the Green Books because they stand in the way of this Inquiry. That request is repeated. This Commission should characterize the Green Books as a biased, inaccurate and unfair analysis of an industry that has contributed significantly to Canada's economic development. They do a disservice to the office of the Director.

Because the Green Books bear the seal of a department of government, they have some credibility. They have generated anger against the industry by concerned members of the public, the press and government leaders. Even more outrageous is the fact that the Director's staff at this Inquiry seems to have made little effort to prove the basis of his attack upon petroleum companies made in the International sector.

Evidence to Date

The Director and those opposed in interest to the larger oil companies have not presented credible evidence or information to demonstrate a competition issue. The authors of the Green Books have not been identified nor presented for cross-examination. No real effort has been made to prove the many allegations against oil companies or indeed to confront, cross-examine and

refute the panels of witnesses presented by Imperial Oil. The credible evidence and information tendered to date demonstrates a lively and competitive petroleum industry in Canada, and shows that relations between Canadian companies and foreign majority shareholders have worked to the advantage of Canadian shareholders and consumers.

Texaco Canada Evidence

Texaco Canada proposes to present a brief prepared under the direction of its counsel to include:

Texaco Canada's written response to the Green Book allegations in Volumes I and III.

The significance of the relationship between Texaco Canada Inc. and Texaco Inc.

Texaco Canada's role and activity in the development of the petroleum industry in Canada.

October, 1982

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PART I

GENERAL OVERVIEW

A. Unusual Characteristics of the Canadian Petroleum Market

To properly understand Canada's position in the world crude oil market, it is important to identify some unusual characteristics in the Canadian market:

In international terms, Canadian refineries use a relatively small amount of crude oil to serve Canadian markets; significantly as well Canadian refineries have access to substantial domestic production;

Although Canada produces much of its crude oil requirements in the West, it has traditionally been dependent on imports for refineries in eastern Canada;

Canada's climate, population mix and transportation system create special and somewhat unusual demands for petroleum products and product mix; and

Canada has always been to some extent dependent on international crude oil supplies. Security of crude oil supply in attractive quality has always been an important objective of efficient Canadian refineries. Canadian refineries were designed to meet demands in Canada which emphasized lighter, gasoline products as opposed to fuel oil products in greater demand in other parts of the world.

The above considerations are dealt with in considerable detail in the Second Submission to the Restrictive Trade Practices Commission by Imperial Oil Limited.

B. History of the Petroleum Industry in Canada

Texaco Canada has played a part in the discovery and production of oil and natural gas in Canada and in the refining and marketing of petroleum products. Its activities must be seen in large measure as a response to Canadian demand and to the activities of its competitors. Its role can best be understood by seeing its place within the industry as a whole.

(i) General Comments

The Director selected the period from 1958 to 1973 for his review of the state of competition in the petroleum industry. Texaco Canada believes that background information would be helpful to this Commission in understanding the events under review in this Inquiry and in considering the issues in each of its phases. This part of the Submission is intended to be an historical overview of the petroleum industry in Canada up to the present time.

Integrated Petroleum Activities

EXPLORATION

Exploration for oil and gas involves more than drilling a hole in the ground. Experienced personnel must evaluate the findings of geological and geophysical programs and identify prospective areas. Mineral rights in prospective areas must be acquired in open competition with others and surface rights negotiated for entry on the lands. Drilling programs must be planned with high regard for safety and environmental protection and, finally, the necessary equipment and supplies acquired and moved into place — often in hostile locations, some accessible only in the depth of winter. If the exploratory wells are promising, a new set of decisions must follow: Is

the field of commercial size? How many development wells are required and on what spacing? Is enhanced recovery required — if so, when and what type? How and when will the oil or gas be moved to market? What facilities are required for gas conservation or processing?

REFINING

The refining of petroleum involves more than boiling oil. Experienced analysts must estimate the demand for products by type and determine specifications accordingly.

They select the variety, range of grades and costs of potential crude oil supplies and prepare the engineering design and specifications for the unit or series of units to be constructed. A decision to build a new refinery involves a new series of activities needing experienced personnel possessing additional skills. Real estate requirements, environmental impact assessments, water supply, its treatment and effluent quality, as well as marine, railway and truck handling facilities are all areas that require sophisticated attention. The supply of crude oil and the shipment of products requires the engineering skills of assessment of the intake, storage and outflow needs and capability of the system to cope with the seasonal variation of product demand and changing specifications.

MARKETING

The marketing of petroleum involves much more than pumping gasoline into the tank of an automobile. Personnel, experienced in the selling of products to customers whose requirements vary from a few to millions of gallons, must be trained and become proficient in merchandising techniques, advertising, sales promotion, financial counselling, product characteristics and must possess a working knowledge of the equipment and processes used by existing and potential customers.

DISTRIBUTION

A distribution system must be established for product delivery. Aviation fuels are required at airports wherever located; motor fuels are needed in urban communities, on the farms, in fishing ports and at marinas; light, intermediate and heavy fuels are required for domestic and industrial purposes; solvents, naphthas and petrochemical products are delivered for use in industrial processes and for production of petroleum based “synthetic” materials; lubricants, waxes, asphalts, liquefied petroleum gases and specialty products are designed, in some cases, for the needs of a single customer.

Of course, it must be remembered that for every litre or gallon of product prepared for market in a refinery, a comparable quantity of the raw material from which the product was extracted has been purchased, transported, processed, blended or compounded in the various manufacturing operations.

(ii) Refinery Costs and Product Pricing

The demand for petroleum products varies significantly from region to region in Canada. This variance is more dramatic in Canada because of geographic and climactic factors and differences in lifestyle. For example, comfort heating creates a high demand for light fuel oil in Eastern Canada while demand in Western Canada is proportionally smaller due to the greater use of natural gas. Ontario and Quebec have roughly comparable per capita demand for gasolines but

demand for the premium grade is significantly higher in Quebec. The more extensively industrialized East consumes a much higher proportion of the heavy ends of a barrel of crude oil. Thus, Texaco Canada, along with its competitors, is faced with the problem of catering efficiently to consumer preferences across our large country.

One company might place greater emphasis on the production and marketing of gasolines and another may see greater market potential in placing more emphasis on the production and marketing of middle distillates. Such strategies will vary in different regions and at different times. Efficient refinery operation demands effective forecasting and adjustment to demands in various regions.

Not surprisingly, the major refiners in Canada have somewhat different yield structures. Those yields differ because of factors including refinery configuration and crude oil quality. For example, Texaco Canada's yields of gasoline range from one-third of crude oil runs in Eastern Canada to as much as two-thirds in Western Canada. In order to achieve the desired mix of products, refiners not only employ various refining units and techniques, but also use different grades and combinations of crude oil and other raw materials.

While all refineries are able to process most grades of crude oil, each refinery is customized to yield and maximize the desired output of products according to a specific grade of input crude oil or mix of crude oils. Each refiner, therefore, has a different cost structure because it produces a different range of products from a selected mix of raw materials.

Crude oil purchasing decisions and capital investments in refineries are based on forecasts of financial results including return on capital.

In today's circumstances, a Canadian refiner will probably use refining units and crude oil slates that will maximize gasoline yield in order to respond to the perceived balance of demand for petroleum products. A refiner must decide whether the higher capital costs and higher input costs for optimum gasoline production will be offset by the higher price the company will realize when selling the product. The refiner concentrating on the lower-end products will have lower costs, but will also realize lower product prices.

To remain profitable, refiner-marketers face a myriad of decisions. They must forecast product demand and price levels. They must decide in which markets they wish to compete, how they will manufacture, at what cost and with what raw materials.

In Canada, and in North America generally, the refining industry has a high degree of sophistication, primarily as a result of the extensive use of the automobile and the corresponding demand for gasoline. Accordingly, those refineries geared to the gasoline market have had to develop means of extracting more gasoline per barrel of crude oil than their competitors in order to remain viable. The legislated mandate for cleaner air and the concurrent development of lead free gasoline have also contributed significantly to the escalation of the refining industry's capital costs.

In Europe, the greater use of heavier petroleum products for heating and electric generation and other industrial purposes, along with a more intricate public transportation network and correspondingly lower level of automobile use, have allowed for the construction of less complex and, hence, less expensive refining configurations.

We now describe the industry at significant periods of time.

(iii) The Canadian Petroleum Industry After World War II

As Canada entered the post-war recovery period, petroleum demand averaged about 222,000 barrels daily.¹ This was equivalent to an annual consumption rate of about 6½ barrels per capita² based on a population of some 12 million.

Production

Production of crude oil and natural gas liquids averaged about 21,000 barrels daily,³ equivalent to approximately 10 per cent of the total crude oil runs in Canada.

Marketed production of natural gas probably averaged about 0.1 billion cubic feet daily — enough to heat about 4 to 5 per cent of Canada's 3 million or so households.

Proved recoverable reserves of crude oil and natural gas liquids were estimated at 150 million barrels — equivalent to about 20 years' supply at the rate of withdrawal in 1946. Proved recoverable reserves of marketable natural gas were probably in the range of 3 to 4 trillion cubic feet.

Refining

There were 31 refineries having an aggregate capacity of 247,000 barrels daily⁴ — an average of about 8,000 barrels daily. Fourteen of these having an average capacity of 14,600 barrels daily, were located on Canada's principal waterways and were supplied by tanker or pipeline. The remainder, having an average capacity of 2,400 barrels daily, were "inland" refineries situated mainly in the Prairie Provinces. Crude oil supplies reached these refineries principally by road or rail transportation facilities.

Canadian refineries processed some 196,000 barrels daily⁵ — approximately 79 percent of rated capacity at year-end.

Gasoline was the product in greatest demand representing about 42 per cent of total requirements.⁶ Octane numbers of motor fuels, which had declined during the war years, were raised to about 85 and 79 for premium and regular grades respectively,⁷ as the refiners responded to the increased quality requirements of a resurgent automotive industry. Middle distillates, which were used mainly for space heating purposes at that time, accounted for 19 percent of demand. The heavy grades of industrial-type fuel and other products including asphalt, lubricants, petrochemical feed stocks and liquefied petroleum gases, represented 21 and 9 percent respectively of petroleum demand. Fuel used in the refining process, conversion losses as well as storage and transportation losses in the distribution of products accounted for the remainder.⁸

Marketing

Facilities for the retail distribution of gasoline began to expand rapidly in the late 1940's as competing companies and their dealer networks tried to capture as many customers as possible. Attractive appearance, convenience of location, ease of access and the provision of skilled maintenance and repair personnel to service the growing number of increasingly complex motor vehicles were some of the matters considered when expanding or establishing retail outlets. Texaco products were sold at retail through a dealer network of independent businessmen.

Facilities for the wholesale distribution of a wide range of petroleum products were also expanded in size and in number to provide improved service to increasingly important markets

such as farms, then engaged in a growing process of mechanization, and distributors of fuel oils to a large number of homes then being converted from coal to oil for space heating.

Demand for new products from petroleum such as jet fuels, petrochemicals and specialty lubricants began to emerge.

Through these early years of renewal and expansion as well as in the maturing years which followed, personnel within the industry were engaged in planning, designing, financing, constructing and ultimately operating the new facilities to supply Canadians the right products and services in the right place at the right time.

Post-War Expansion

Following the Second World War, Canada began the task of restructuring its industrial output, replacing old and worn-out facilities and building new plant and equipment to meet the pent-up demand.

Canadians expected once again to acquire the goods and services which had been unavailable or in short supply for so many years and there was a general air of optimistic expectation about the future.

The Dominion Bureau of Statistics in its publications *The Crude Petroleum Industry in Canada, 1946* and *The Natural Gas Industry in Canada, 1946*⁹ reported that there were 240 firms engaged that year in the production of crude oil and 219 in the production of natural gas. A similar publication *Petroleum Products Industry, 1946* indicates that there were 39 firms engaged in the refining of crude oil and/or the compounding of lubricants. Data concerning marketers of petroleum products were not available.

Petroleum companies engaged in the search for the oil and gas resources which Canada was thought to possess, no doubt would have preferred to finance the entire cost in order to retain full rights to any discoveries. Even companies with relatively substantial assets, however, deemed it prudent to seek partners who would share the financial burden in the high-risk ventures at that time. And the experience in Canada prior to 1946 was not encouraging — only enough oil to supply one-tenth of Canada's needs in 1946 remained after all of the discoveries of the previous 30 years.

The Northern Foothills Agreement, to which Texaco Canada was a signatory, was an example of the type of arrangement which was concluded in the 1940's to minimize the risks which were perceived.

Agreements such as this were not designed, as the Green Books suggest, to usurp the choice sites or to shut out competition. Rather, they were intended to enable the participants to continue exploratory work and to share in the expected risks. The particular land sites chosen for exploration were, in the best judgment of the technicians, those in which the prospects for oil discoveries were considered encouraging at that time. Oil and gas discoveries on land sites selected under the Northern Foothills Agreement did not prove to be particularly successful.

Other companies with sufficient capital resources and the necessary technical skills were perfectly free to make their own arrangements and to select sites from the many millions of acres of prospective lands in the western sedimentary basin.

The development of oil and gas resources in Western Canada did not stem from a particularly favourable tax treatment of petroleum companies. Tax incentives in Canada were

generally competitive with incentives in other parts of the world where prospects were at least as favourable and which would otherwise have attracted the capital needed to develop one of Canada's most essential natural resources — a resource which has brought great wealth to governments in Canada today.

The 16 petroleum companies which operated Canada's 31 refineries in 1946 recognized the need for a substantial increase in capacity to meet the anticipated surge in demand as well as to improve product quality. Twelve of these refineries were of the skimming variety which yielded a high proportion of light and heavy fuel oils and a limited quantity of gasoline — a combination which did not fit the Canadian pattern of the existing or anticipated mix of products.

To meet the market demand for quantity as well as quality, petroleum refineries were eventually expanded and equipped with new cracking facilities to convert the heavier products to the lighter, more valuable grades using processes which had been developed, tested and proven successful in the United States. These processes were generally available under license.

Lubricating oil and grease making facilities also were to undergo extensive expansion and modernization to provide for a greater variety of products able to protect machinery and equipment during increasingly severe operating conditions.

(iv) The State of the Industry in 1958

In 1958, as Canada's economy continued to expand at a rapid pace, petroleum demand averaged about 760,000 barrels daily¹⁰ — a growth of about 10.8 percent per annum in the 12 year period since 1946. Demand per capita was about 16 barrels.

Production of crude oil and natural gas liquids averaged 462,000 barrels daily,¹¹ equivalent to about 70 percent of the daily rate of crude oil runs in Canadian refineries. Production increased at a rate of nearly 30 percent per annum between 1946 and 1958.

Marketed production of natural gas averaged nearly 0.8 billion cubic feet daily¹² — approximately equivalent to the fuel requirements of 12-13 percent of the 4.2 million households in Canada. Marketed production increased at an average annual rate of about 16 percent through this 12 year period.

Proved recoverable reserves of crude oil and natural gas liquids at the end of 1958 amounted to 3.6 billion barrels¹³ — 24 times as much as in 1946. During this 12-year period the petroleum industry found 4.5 billion barrels of recoverable oil and produced 1 billion.

Proved recoverable reserves of marketable natural gas amounted to 20 trillion cubic feet¹⁴ — a six-fold increase over 1946. The petroleum industry found new reserves of about 18 trillion cubic feet and produced for sale about 1 trillion.

Seventeen new refineries were built in Canada between 1946 and 1958 and six refineries ceased operations. In 1958, there were 42 petroleum refineries having a total capacity of 828,000 barrels daily, an average of nearly 20,000 barrels daily.¹⁵

These refineries operated at about 80 percent of their nominal capacity with crude oil runs averaging about 659,000 barrels daily.¹⁶

By 1958, there were 32 pipelines transporting crude oil and natural gas liquids to refining centres and finished products to the marketplace. More than 750,000 barrels daily of petroleum was moved through the 5,000 miles of pipelines.¹⁷

Gasoline was still the product in greatest demand but by 1958 it represented only 36 percent of total petroleum requirements.¹⁸ Octane ratings climbed to 98 and 90 for premium and regular grades¹⁹ in response to the need for fuels which met the higher compression ratio of new and more powerful engines.

Registrations of motor vehicles reached a level of about 4¾ million,²⁰ an increase of 9.3 percent per annum. On the average during this 12 year period, over 700 new motor vehicles were added *every day* to the streets, roads and highways of Canada. In addition, the population of farm tractors increased to about 440,000 from an estimated 200,000 in 1946²¹ as mechanization of farming methods proceeded at a rapid pace.

New retail outlets and bulk distribution facilities were built to serve the requirements not only of automobiles, trucks and tractors but of a growing number of gasoline engines used in labour-saving devices and for recreational purposes.

During the 12 year period, demand for middle distillate products increased dramatically. Coal and wood were displaced because of the availability of efficient oil burning equipment, including diesel engines. Demand for such product grew annually at the rate of 16½ percent during that period. By 1958, middle distillate products represented 34% of petroleum products sold in Canada. Approximately 4% of the distillate portion was jet fuel, 23% diesel fuel and 73% heating fuel.

Heavy fuel oil demand grew more slowly than total demand thus reducing the proportion of this product to 16 percent of the total barrel. Other products maintained their 8 percent share while refinery fuel and loss diminished to 6 percent as a result of the greatly improved efficiency of the new or expanded refineries in Canada.²²

(v) Development and Change 1958-1973

By 1973, demand for petroleum products in Canada reached the level of 1,729,000 barrels daily.²³ The growth between 1958 and 1973 averaged 65,000 barrels per day per year which was more than enough to support the entry of one new refinery annually. Production of crude oil and natural gas liquids reached a new peak of 2,116,000 barrels daily during 1973.²⁴ On balance, Canada was more than self-sufficient in crude oil supply with production being in excess of demand by nearly 400,000 barrels daily in 1973. About two percent of the supply consisted of synthetic crude oil made from the Athabasca oil sands. The annual growth rate between 1958 and 1973 averaged 10.7 percent. Oil wells in Canada were able to produce an additional 110,000 barrels daily each year as the result of new discoveries or extensions of existing fields including enhanced recovery projects such as water or miscible flood techniques.

Marketable production of natural gas averaged nearly seven billion cubic feet daily,²⁵ an increase of 15.8 percent per annum during the 15 year period. Domestic requirements amounted to four billion cubic feet daily — enough to provide the fuel requirements of one-third of the households in Canada as well as a significant amount for industrial processes.

Proved recoverable reserves of crude oil and natural gas liquids at the end of 1973 were 10.5 billion barrels.²⁶ During the period from 1958 through 1973, production in Canada amounted to six billion barrels. The petroleum industry discovered nearly 13 billion barrels of oil during the 15 year period.

Proved recoverable reserves of marketable natural gas trebled from 1958 to reach 61 trillion cubic feet in 1973.²⁷ Nineteen trillion cubic feet of gas was delivered to markets in Canada and

the U.S. during this period of time. The petroleum industry discovered some 60 trillion cubic feet of new reserves, an amount which is equivalent in heating value to 10 billion barrels of oil.

Ten new refineries were constructed and 12 were closed between 1958 and 1973. At the end of 1973, Canada had 40 operating refineries whose aggregate capacity was 1,757,000 barrels daily, an average of about 44,000 barrels daily — more than doubling over the period.²⁸

Crude runs in all refineries amounted to 1,683,000 barrels daily, equivalent to about 96 percent of capacity.²⁹

Pipelines, in 1973, carried some 2,900,000 barrels daily of crude oil and natural gas liquids to refineries in Canada or to export markets in the United States and of finished products from gas processing plants and refineries to markets in Canada.³⁰ These systems offered the only practicable solution to the year-round, efficient transportation of such substantial quantities of petroleum from inland sources such as prevail in Western Canada.

Gasoline was no longer the dominant petroleum product in demand in Canada. It shared its position with middle distillate products where each group represented one-third of total petroleum demand.³¹ Octane ratings reached new levels of 99.3 and 93.5 for premium and regular grades as automobile engines continued to increase in power.³²

There were 10.2 million registered motor vehicles in 1973³³ — more than double the number in 1958. New registrations grew at an annual average of 5.2 percent as nearly 1,000 automobiles and trucks entered Canada's road systems *every day*. And the number of farm tractors reached a level of about 570,000 or 30 percent greater than in 1958³⁴ — a growth rate of 1.8 percent per annum.

The distillate fraction of demand consisted of 10 percent jet fuel, 31 percent diesel and 59 percent heating oils, contrasted with 4, 23 and 73 percent respectively in 1958. The growth rate per annum was 11.4 percent for jet fuels, 7.5 for diesel and 3.9 for heating oils.

Heavy fuel oil demand increased more rapidly than total demand and represented 18 percent of all petroleum used in 1973. Other products and plant fuel and loss were 10 and 6 percent respectively of the total.³⁵

Major marketing facilities were expanded to bring a full range of petroleum products within relatively easy reach of wholesale, commercial and retail customers. It was assumed that villages, towns and cities would expand and new communities would be created, that oil would displace vast quantities of coal in urban areas and that farms would have access to oil heating as a result of the rural electrification programs. A significant increase in demand was foreseen because of the increased availability of farm machinery using gasoline, diesel and propane fuels for power purposes, using lubricants for such equipment and light fuel oils for space heating.

The anticipated demand for gasoline resulted in an incentive and competitive requirement to put in place convenient and efficient distribution centres. Competition for the gasoline market resulted in the growth of many relatively small retail outlets.

For its part, Texaco Canada was determined to maintain and if possible increase its market share. It made direct investments in exploratory ventures where warranted or participated with others to conserve capital; its refinery expansion or new-building decisions were keyed to the company's marketing strategies. The company's goal was to improve its short term and long term earnings and financial strength.

The Chase Manhattan Bank in the United States has for many years conducted studies of the financial performance of a large number of petroleum companies. In one of its annual publications, *Capital Investments of the World Petroleum Industry*,³⁶ it provides estimates of capital investments in Canada.

According to that publication, the Canadian petroleum industry invested approximately \$22 billion from 1946 through 1973. About \$14½ billion, or two-thirds of the total, was used to explore for and develop oil and gas reserves and build facilities to process natural gas for domestic and export markets. Nearly \$6 billion, or one-quarter of the total, was devoted to the building of refineries, including petrochemical plants, and construction of wholesale and retail marketing facilities. About \$1½ billion was used to build pipelines, tankers and other assets required in the handling of petroleum and its products.

From a modest capital expenditure level of about \$50 million in 1946, the petroleum industry gradually accelerated the pace to some \$700 million in 1958 and \$1.8 billion in 1973. These capital investments reflected the multitude of decisions which each participating company made in pursuit of its goals and objectives. There were producing companies without refining or marketing facilities, companies with productive capacity beyond their refining needs and companies without adequate production to service their refineries. Some companies had huge resources of natural gas. Others' sole business was to market gasoline, heating oils or lubricants, or a combination of these. Finally, some companies depended entirely upon imports of either crude oil or product.

(vi) Developments Since 1973

Between 1973 and today, dramatic changes reshaped the petroleum industry throughout the world.

Governments intervened to take control of production and pricing of petroleum. Prices, which had for decades responded to the pressure of supply and demand, were suddenly subject to arbitrary increases of substantial proportions.

Under the pressure of rapidly increasing crude oil prices — many of which eventually reached levels some 20 times those which previously prevailed — petroleum demand began to subside.

The Government of Canada chose to isolate this country from the direct effects of higher petroleum prices by restraining the price of domestic crude oil and subsidizing refiners for imported supplies bought at world price levels and by promoting the use of natural gas to reduce Canada's dependence upon oil.

This strategy, combined with the effects of the economic slow-down which Canada has been experiencing along with most other countries, caused a decline both in the consumption of petroleum products and in Canada's many petroleum related activities.

By 1981, demand for petroleum products in Canada amounted to about 1,769,000 barrels daily,³⁷ a slight decline from peak years but still about 26 barrels per year per capita, one of the highest in the world.

Production of crude oil and natural gas liquids approximated 1,345,000 barrels daily during 1981.³⁸ Canada was no longer self sufficient as demand for crude oil exceeded domestic supply by over 400,000 barrels daily. Synthetic crude oil from two extraction plants provided a small percentage of the total supply. The production rate declined at 5.5 percent per annum during the eight year period.

Production of natural gas for market averaged 6.6 billion cubic feet daily,³⁹ a decrease of 0.6 percent per annum during this period of enforced domestic growth. About 40 percent of Canada's 8 million households used natural gas as their principal fuel.

Proved recoverable reserves of crude oil and natural gas liquids at the end of 1981 were 7.9 billion barrels compared with 10.5 billion barrels in 1973.⁴⁰

Proved recoverable reserves of marketable natural gas increased to 90.5 trillion cubic feet in 1981⁴¹ as new discoveries were made principally in the Deep Basin area of Alberta and British Columbia.

Between 1973 and 1981, one new refinery was built and six ceased operations leaving 35 operating refineries in Canada at the end of 1981. These plants had an aggregate crude oil intake capacity of 2,058,000 barrels daily, an average of approximately 59,000 barrels daily.⁴²

Crude runs in 1981 amounted to 1,762,000 barrels daily, equivalent to 86 percent of operating capacity.⁴³

Pipelines carried some 2,700,000 barrels daily of crude oil and natural gas liquids in 1981.⁴⁴ All refineries in Canada are either connected to pipelines or are able to receive crude oil supplies by ocean tankers from overseas.

Gasoline once again became the dominant petroleum product used in Canada.⁴⁵ Middle distillate sales declined largely as a result of conservation efforts and government policies. The prevalence of smaller automobiles and the more stringent levels of fuel economy and environmental standards being observed by the automotive industry brought about the widespread use of lead-free gasoline and a reduction in octane levels.

There were about 14 million registered vehicles in Canada in 1981,⁴⁶ an increase of about 4.0 percent per annum during the eight year period. Over 1,300 vehicles were added to the road systems in Canada *each day* between 1973 and 1981. However, there was a noticeable drop in the average annual use of fuel per vehicle, from 725 gallons in 1973 to 600 gallons in 1981 — a decrease of about 17 percent.

The number of tractors in use on farms in Canada continued to increase, reaching about 658,000 in 1981 compared to 570,000 in 1973,⁴⁷ a growth rate of 1.8 percent per annum.

Distillate demand actually decreased during the period at a rate of about one-half of one percent per annum. While demand for jet and diesel fuels increased by about 4 percent per annum, demand for heating oils declined by about 5 percent per year.

Heavy fuel oil demand dropped by 4 percent per annum during this period, reflecting mainly the dramatic decline in Canada's industrial output.⁴⁸

A comparison of petroleum demand and some of the factors associated with its growth over the period 1946 to 1981 are portrayed in Table 1, following:

TABLE 1

The Petroleum Industry in Canada and Its Growth From 1946 to 1981

Unit	1946	1958	Annual Growth %	1973	Annual Growth %	1981	Annual Growth %
Producing							
Crude Oil & Nat. Gas liq.							
Reserves	150	3,648	30.5	10,500	7.3	7,909	(3.5)
Production	21	462	29.5	2,116	10.7	1,345	(5.5)
Natural Gas							
Reserves	3.5	20.5	15.9	61.4	7.6	90.5	5.0
Production	0.1	0.8	16.0	6.9	15.8	6.6	(0.6)
Refining							
Operating Plants	31	42		40		35	
Crude Oil Capacity	247	828	10.6	1,757	5.1	2,058	2.0
Crude Runs	196	659	10.6	1,683	6.4	1,762	0.6
Utilization Rate	79%	80%		96%		86%	
Marketing							
Total Demand	222	760	10.8	1,729	5.6	1,769	0.3
Gasolines	94	272	9.3	575	5.1	660	1.7
Distillates	42	261	16.5	574	5.4	554	(0.5)
H.F.O.	47	119	8.0	307	6.5	224	(3.9)
Other Products	21	65	10.0	176	6.9	240	4.0
Plant Fuel & Losses	18	43	7.6	97	5.6	91	(0.8)
Other Factors							
Population	12.3	17.1	2.8	22.2	1.8	24.4	1.1
Households	3.0	4.2	2.8	6.3	2.7	8.0	3.1
Oil Heated .....	.4	2.2	15.4	3.5	3.1	2.8	(2.6)
Oil Heated Share	12%	52%		55%		35%	
Registered Vehicles	1.6	4.7	9.3	10.2	5.2	14.0	4.0
Farm Tractors .....	.2	.4	6.8	.6	1.8	.7	1.8
Petroleum Demand/Capita ..	6.6	16.2		28.4		26.1	

PART II

RELATIONSHIP BETWEEN TEXACO CANADA AND ITS MAJORITY SHAREHOLDER

A. Texaco Canada Decisions

Employees of Texaco Canada relied extensively on the help and expertise of Texaco Inc. in technical matters, including the acquisition and transportation of crude oil. As majority shareholder, Texaco Inc., through representation on Texaco Canada's Board of Directors, had a financial interest and, accordingly, a regular involvement in the financial affairs of Texaco Canada. Decisions were arrived at on a co-operative basis following consultation and discussion between the companies. All concerned recognized the unique character of Texaco Canada, including the existence of its minority shareholders. Canadians, of widely diversified business experience, have consistently been in the majority in the company's Board of Directors. As a result, Texaco Canada was in a position to profit and grow because of the contribution of its outside directors and the strength and encouragement of its majority shareholder.

Texaco Canada relied upon the help that it received from its parent and it did not identify any significant financial advantage in duplicating crude oil acquisition or transportation facilities on an independent basis. Until 1979, the company purchased all of its imported crude oil from Texaco Inc. or its affiliates. As a result, Texaco Canada was able to compete effectively and profitably in the markets in which it operated.

B. History of the Affiliation

The company now known as Texaco Canada Inc. originated in 1927 with the merger of McColl Brothers Limited of Toronto and Frontenac Oil Refineries Limited of Montreal into McColl-Frontenac Oil Company Limited. Predecessors of the two merged companies trace their history to 1873.

The high rate of growth during the early to mid-1930's placed a strain on the capital resources of the company, at a time when Canada's economy experienced the worst depression of this century. However, competition within the petroleum industry, which included many small regional firms, remained strong. Faced with these mounting challenges, the directors decided that association with a larger, international organization was desirable and necessary to provide the financial resources needed for continued expansion.

At this time The Texas Company (later to become Texaco Inc.), a large U.S. organization having world-wide petroleum operations and interests, was encouraged to invest in the Canadian company by McColl-Frontenac's directors.

By early 1938, The Texas Company had acquired about 35 per cent of the outstanding common shares of McColl-Frontenac.

Prior to 1938, the company's marketing area extended from the Maritimes to Manitoba, with limited representation in the other Western provinces. When the distribution network which The Texas Company of Canada Limited had operated since 1928 in Saskatchewan, Alberta and British Columbia was purchased in 1939, the company's area of marketing operations was thereby extended westward to the eastern portion of British Columbia.

In 1940, the company further expanded its operations with the acquisition of a majority interest in B.C. Fuel Co. Ltd., thus making the company a coast-to-coast operation.

In 1957, the company acquired substantially all of the outstanding shares of Regent Refining (Canada) Limited, thereby materially increasing its share of the petroleum market in Ontario.

In 1958, shareholders of McColl-Frontenac Oil Company Limited approved a change of the company's name to Texaco Canada Limited.

Finally, in 1960, eleven years after Newfoundland entered Confederation, the company acquired a controlling interest in Great Eastern Oil and Import Company of Newfoundland, thereby making Texaco brand products available in all provinces of Canada.

A period of expansion followed. Texaco Canada invested in refining, marketing and distribution facilities in order to compete in the market. It prospered, successfully contending with competition from new and established competitors. Although its market share changed regionally and locally, it was able to maintain and increase its role in the industry in the face of stiff competition. It met the challenge of new entrants, including many small, regional marketers and relatively large companies such as Liquifuels, Canadian Petrofina and British Petroleum.

Effective June 1, 1978, the company amalgamated with Texaco Exploration Canada Ltd. and subsequently was continued under the name Texaco Canada Inc.

Texaco Canada prospered and maintained its comparative effectiveness in large measure because of the support of the capital resources, management skill, counselling and general know-how provided by representatives of its majority shareholder.

From its 35 percent holding in the company in 1938, Texaco Inc., or its predecessor, gradually increased its position to 54 percent in 1948, and to 68 percent in 1962. Following the amalgamation of Texaco Canada and Texaco Exploration Canada Ltd., in 1978, the Texaco Inc. holding increased to 89.6 percent.

In summary, it is highly unlikely that Texaco Canada or its predecessor companies could have played as significant a role in the development of the petroleum industry in Canada without the capital, assistance and support of a strong and sophisticated majority shareholder.

C. Benefits Accruing to Texaco Canada From Its Affiliation With Texaco Inc.

(i) Access to a Variety of Crude Oils on a World-wide Basis

The company's refining facilities have expanded over the years. In 1928, they consisted of small plants in Montreal and Toronto. The company expanded its Montreal refinery capacity and constructed new facilities in Edmonton, Halifax and Nanticoke. As well, the company added a refinery at Port Credit with the acquisition of Regent Refining in 1957. Refining operations at Toronto and Port Credit ceased in 1949 and 1978 respectively. Recently, the company announced that refining operations at Montreal would be suspended.

Texaco Canada's refineries in eastern Canada were designed to use imported crude oils which were expected to be available on a long term basis. The characteristics of these crude oils were best suited to the production of products needed for the company's marketing strategies in the areas served by those refineries.

Market conditions, however, undergo gradual and sometimes significant changes over time, such as the reduction of sulphur content in fuel oils, the introduction of lead free gasoline and the birth of the petro-chemical industry. The mix and specifications of products may be altered

sufficiently to require new processing techniques, new refining equipment, a new slate of crude oils or any combination of these.

Since 1955, Texaco Canada's refineries in eastern Canada have processed approximately 30 types of crude oil imported from the 11 countries set out below:

Algeria	Nigeria
Columbia	Saudi Arabia
Equador	Trinidad
Iran	United States
Libya	Venezuela
Mexico	

These oils did not fortuitously meet the company's requirements — they did so on a planned basis. The refineries had been built or modified to accommodate crude oils whose availability the company foresaw on a long-term basis at attractive prices.

In particular, the fact that Texaco Inc. was a major shareholder in Aramco, with secure access to large quantities of Arabian crude oil, was one of the factors considered by the company in its crude oil acquisition decision. This in contrast to the greater dependency by other Canadian companies on Venezuelan crude oils.

At no time during the period under discussion did the company experience other than minor problems with the quantity and quality of its crude oil slates.

In addition to these imported crude oils, the company used Canadian crude oil in its Eastern refineries commencing in 1973.

(ii) Security of Supply

To protect its refining and marketing investment and fulfill its commitments to supply the petroleum requirements of one out of every ten Canadians, Texaco Canada required on a long term basis not only access to a variety of crude oils, but reasonable assurances of supply over a continuing period.

When a customer of Texaco Canada burns petroleum for space heating or industrial purposes, in accordance with the contractual arrangements in place, or enters a service station to buy gasoline, it is in the full expectation that the required fuels will be available at that moment of demand; no back-ordering system would be understood or accepted.

Texaco Canada, in 1981, made available at the point of consumption an average of approximately 7 million gallons of petroleum products every day of the year. One-half of these products were processed from crude oil obtained from overseas sources. The company had assurance of supply from Texaco Inc. which did not fail to provide Texaco Canada with crude oils suited to its needs over the years.

Texaco Canada's assurance of supply does not come from an insurance policy or a contract with binding commitments vetted by lawyers. Rather, the assurance comes from an understanding and business practice over the years supported by the very substantial investment that Texaco Inc. continues to hold in the profitability and therefore competitiveness of Texaco Canada.

The company did not have to deal with a multitude of suppliers having no long-term commitment to a customer such as Texaco Canada whose requirements were equivalent to about one-tenth to one-fifth of one percent of the daily crude oil flow of the free-world. It did not have to scramble for alternate supply sources in times of stress.

During periods of crisis in which world crude oil supplies were disrupted by political strife, armed conflicts, acts of sabotage, fires and other conditions which interfered with the normal flow of commerce, Texaco Canada found it unnecessary to invoke the force majeure provisions of contracts with its customers to deny them supply.

When certain crude oils became temporarily unavailable, the company's supplier drew upon its resources and provided substitute crude oils in adequate quantity and of acceptable quality to place Texaco Canada's refineries in a position to meet their obligations.

(iii) Access to World-scale Tanker Fleet

Texaco Canada's ocean tonnage requirements represented less than five percent of the total volume of petroleum carried annually in the fleet owned and leased by Texaco Inc.

This fleet, in which the average size of vessel increased over the years as very large crude oil carriers were added to the complement, contained many vessels which were of a size that best suited the company's requirements.

Because Texaco Canada could depend upon this fleet to provide a steady and dependable flow of supply to its refineries in Montreal and Halifax, it was not necessary to devote an excessive amount of refinery tankage to the containment of crude oil.

The water depth at these refinery docks has been generally maintained at about 35 feet, limiting cargoes to some 235,000 barrels. The company's facilities at Halifax were improved in 1980 and up to 450,000 barrel cargoes can now be accommodated.

Most of the crude oil received at the Montreal refinery, however, moved via pipeline from the Portland, Maine terminal of the Portland-Montreal pipeline system. Prior to 1955, the depth of water at the dock was about 35 feet, thus limiting cargoes at that location to about 200,000 barrels. Improvements to the dock facilities enabled vessels to take full advantage of the 45 feet of water in the Portland harbour, and progressively raised the capability of the system, as set out below.

<u>Year</u>	<u>Approximate Vessel Tons</u>	<u>Approximate barrels carried</u>
	(000)	(000)
1955.....	30	200
1956.....	50	330
1957.....	60	400
1962.....	85	566
1966.....	100-110	666-733

When Texaco Canada acquired Regent Refining (Canada) Limited in 1957, it assumed the obligations of that company which included a Contract of Affreightment with Triton Shipping Inc. This agreement covered the navigation seasons of 1956 through 1965.

Texaco Canada also entered into long term charter agreements in the late 1940's for five ocean vessels. These charters expired in 1951, 1952, 1957, 1959 and 1964. The latter two agreements were assigned to Texaco Panama Inc. prior to their expiry dates.

Because of its access to the world wide Texaco fleet, Texaco Canada was able to take advantage of the significant freight saving by having crude oil destined for Portland delivered by VLCC to the Caribbean and transferred to smaller tankers for delivery to Portland.

(iv) Other Significant Benefits

Tangible and intangible benefits also accrued to the company as a result of its affiliation with Texaco Inc. Some of these are set out below:

- The use of insignia and product brand names which were easily recognized by motorists visiting or touring Canada.
- The reciprocal use, for the convenience of its customers, of the Texaco Travel card at retail outlets throughout the United States and Canada — all under a single insignia.
- Access to certain refining processes.
- Access to the special expertise of Texaco Inc. in many areas, including: engineering and research in the exploration for gas and oil deposits; technological advancements in petroleum refining processes; and in the transportation, distribution and marketing of petroleum products; and the financial and other administrative functions which are required in the development and growth of a business enterprise.

The interchange with Texaco Inc. was not uni-directional. Over the years, Texaco Inc. sent teams of observers to Canada to learn and bring back to its operations the expertise acquired by Texaco Canada in several areas. Among these were self-serve retail operations, merchandising programs linked to Texaco Travel Card mailings and promotional schemes such as the highly successful and often copied “Starburst of Bonuses” program of the 1960’s.

D. Crude Oil Supplies and Prices

(i) The Imports of Crude Oil

Texaco Canada’s strategy in its refining operations at Montreal was to use the optimum quantity of Arabian Light, supplemented by light Venezuelan, crude oils in order to meet the quantity and quality requirements of its marketing operations. The Montreal plant, opened in 1927, was modernized and expanded in 1946. At that time, the processing facilities and metallurgy were designed to handle Arabian crude oil of 34-35° API gravity. This crude oil contained a somewhat higher level of sulphur than would be present in the most commonly used Venezuelan supplies.

The Halifax plant, opened in 1964, was designed to process Venezuelan crude oil of 32-33° API gravity. In 1967, this installation began to use some Arabian crude oil of 34-35° API gravity, after a trial run confirmed that a limited quantity of this grade of feed stock could be processed.

Both of these facilities used Arabian crude oil because it was more economical than supplies from other sources and abundant quantities of this attractive crude were available to Texaco Canada through its affiliation with Texaco Inc.

The Port Credit plant, which was undergoing modernization and expansion in 1956-57 when it was bought by Texaco Canada from Regent Refining (Canada) Limited, was originally designed to process crude oil from Trinidad, but was later modified to use Western Canadian crude oils of 37-38° API gravity.

Crude oil imports into Canada for the company's operations are set out in Table 2, following. Domestic production is included for comparative purposes.

TABLE 2
Texaco Canada
Source of Crude Oil Refined Showing Imports by Origin

	Millions of Barrels						
	Middle East	South America	Africa	Misc.	Total Imports	Domestic	Total Crude
1955.....	8	8			16	3	19
56.....	12	8			20	4	24
57.....	7	14			21	9	30
58.....	13	7			20	9	29
59.....	16	5			21	12	33
1960.....	14	7			21	11	32
61.....	17	4			21	13	34
62.....	15	5			20	12	32
63.....	16	4			20	16	36
64.....	2	17			19	16	35
1965.....	13	5			18	18	36
66.....	14	6			20	18	38
67.....	11	7		2	20	19	39
68.....	16	8			24	21	45
69.....	8	15			23	22	45
1970.....	6	20	1		27	22	49
71.....	6	20			26	22	48
72.....	4	18	5		27	24	51
73.....	8	13	7		28	25	53
74.....	17	9	1		27	31	58
1975.....	13	8	5		26	28	54
76.....	10	11	7		28	28	56
77.....	7	14			21	37	58
78.....	4	14			18	42	60
79.....	8	10			18	53	71
1980.....	11	4			15	53	68
81.....	10	4	2	2	18	47	65

(ii) Crude Oil Suppliers

Texaco Canada concluded crude oil supply contracts for imported crude oil exclusively with Texaco Inc. or its affiliates from the early 1950's until 1979. Thereafter, the company obtained some of its requirements through direct agreements with third parties.

In November 1979, the company entered into a year-to-year agreement with Petroleos de Venezuela S.A. for approximately 12,000 barrels daily of 32° API gravity Venezuelan crude oils. Liftings under this agreement commenced in 1980.

The company reluctantly accepted an assignment of the initial supply of some 5,000 barrels daily of light and heavy Mexican crude oils which became available to Canada in 1981, following a government-to-government agreement. This mixture of crude oils, with an average gravity of about 28° API, is not a desirable feed stock for the Halifax refinery. The company was obliged to run this material at its Montreal refinery, but could only do so when blended with much lighter grade crude oils. Under the provisions of subsection 6(f) of the Petroleum Import Cost Compensation Regulations issued pursuant to the *Petroleum Administration Act*, S.C. 1974, as amended, the company was obliged to accept these quantities of Mexican crude oil even though its quality was such that the company would not have purchased it on the open market.

(iii) Response to the Director's Views of Texaco Canada's Pricing Policy

Alleged Control by Parent Firm — General

The Director's allegations in this area are summarized at page 32 of Volume III of the Green Books:

Canadian subsidiaries of multinational companies paid too much for crude oil because they acted in the interests of their parent company or because they had their crude oil acquisition policy dictated to them.

It is Texaco Canada's submission that this allegation is without foundation.

Throughout the period, the majority of the shares of Texaco Canada were owned by Texaco Inc. Texaco Inc. had a financial interest in insuring the profitability of its Canadian affiliate and thus, in large measure, its interests were identical to those of the affiliate and its minority shareholders. Texaco Canada's crude oil prices represented an important part of its product cost. Its products were sold in markets in which many companies competed. Texaco Canada's growth and profitability are substantial measures of the competitive prices at which it secured its crude oil. Texaco Inc. protected its substantial investment and the financial fortunes of Texaco Canada by contributing advice and support in operational matters.

The seized documents demonstrate that Texaco Canada employees were sensitive to their employer's needs and attempted to secure even lower crude oil prices. They relied on market information, rumors and arguments and the only real measure of their success must be in the market.

The World Crude Oil Market

For many years, the United States was the dominant force in world petroleum markets and that country exerted a strong influence on crude oil prices in South America and the Middle East, where potential producibility was vastly greater than consumption.

Because of its relative ease of handling, cleanliness and widespread availability, petroleum became the fuel which most consumers selected for transportation or heating, and large markets outside the U.S. developed rapidly. Europe became increasingly important as a consuming centre and large-scale refineries were built to serve this growing market. These plants were predominantly of the primary distillation variety which suited the low gasoline/high fuel oil nature of the domestic demand, and were located on deep-water ports capable of accommodating large-scale crude oil carriers.

Rotterdam Market

Large refineries which were concentrated in the Mediterranean, at Amsterdam and Rotterdam in the Netherlands, and in Antwerp, Belgium (the so-called "Rotterdam" market)

became more significant than the refineries of the Caribbean and the American Gulf Coast, and the Rotterdam market became one of the world's major export centres for petroleum products.

Refineries in the Rotterdam area are thought to have relatively long-term supply commitments which fulfill the minimum operating rates of the plants and short-term or spot market sales are sought to bring the total crude runs to more profitable levels. The reported sales of products which make up the Rotterdam market tend to reflect sales of marginal products to uncommitted customers. As well, a single cargo may pass through many brokers' hands without physical movement of the product. Reported prices are, therefore, often unreliable since it is unknown which of the multiple transactions is being reported.

The Rotterdam market was cited by the Director as representative of the world petroleum price structure; by analysing the prices at which products are offered for sale to non-committed, spot buyers and by converting such data to crude oil equivalent, it is said to be possible to arrive at the buyer's theoretical cost of crude oil at the port of loading.

This derived cost, however, is directly related to sales made at prices which, if applied to the entire output of a refinery, would be insufficient to keep the enterprise in business. Full operating costs, including a return on capital employed sufficient to satisfy the investors, would differ from plant to plant. The largest unit would tend to have the lowest overall unit cost, reflecting the economies of scale.

However, these same refineries would have similar incremental costs to be recovered from spot sales, and a small margin of profit — albeit too small to support the full refining costs — would, nevertheless, be sufficient to make a contribution to overhead.

Table 3, following, sets out the estimated contribution to overhead of marginal sales ex Rotterdam refineries running Arabian Light crude oil during the years 1975 to 1978. The information contained in this table was derived from charts in the article by Joe Roeber "The Rotterdam Oil Market", *Petroleum Economist*, April, 1979.⁴⁹

TABLE 3
Rotterdam Refineries
Landed Cost of Arabian Light Crude Oil vs. Gross Product Worth

	\$.U.S. PER BBL.			
	1975	1976	1977	1978
Primary distillation				
Gross product worth.....	13.00	14.40	15.30	16.40
Cost of Arabian light	13.10	14.19	15.10	15.66
Conversion fuel @ 4%.....	.52	.57	.60	.63
Apparent contribution.....	(.62)	(.36)	(.40)	.11
Primary plus upgrading				
Gross product worth.....	13.90	15.50	16.40	17.85
Cost of Arabian light	13.10	14.19	15.10	15.66
Conversion fuel @ 5%.....	.66	.71	.76	.78
Apparent contribution.....	.14	.60	.54	1.41

Note:

- 1) From the apparent contribution, a refiner would have to deduct the cost of working capital for crude oil and product inventories and credit terms, if any.
- 2) Refineries with only primary distillation facilities likely would incur out-of-pocket losses if sales were to be made at prices comparable to those of refineries with upgrading equipment.

Texaco Canada believes that export markets such as Rotterdam exist because the refineries concerned have a committed base load at prices which are not related to incremental economies but rather to prices which reflect the recovery of full costs, including an acceptable level of profit.

The company submits that a comparison of derived crude oil prices between incremental sales in the 13 million barrels-a-day markets of western Europe and the 2 million barrels-a-day markets of Canada is not a valid method of determining what Canadian refiners should expect to pay for imported crude oil.

Table 4, following, establishes a comparison of the refineries of Western Europe and Canada both as to their numbers and as to their crude oil capacities. The data is derived from the *International Petroleum Encyclopedia* for 1981.⁵⁰

TABLE 4
Comparison of Refineries in Western Europe and Canada

	Number of plants	Crude oil capacity	
		Total	Average
		Thousands of barrels daily	
Western Europe			
Italy	32	4,092	128
France	22	3,341	152
Germany/Austria	32	3,301	103
U.K.	19	2,629	138
Netherlands	8	1,827	228
Spain	10	1,469	147
Belgium	8	1,056	132
Sweden	6	451	75
Norway	4	253	63
Denmark	3	215	72
Switzerland	2	102	51
Ireland	1	56	56
	<u>147</u>	<u>18,792</u>	<u>128</u>
Canada			
Atlantic, Quebec and Ontario	19	1,633	86
Western Provinces	17	536	32
	<u>36</u>	<u>2,169</u>	<u>60</u>

From Table 4, it can be seen that the refineries of Western Europe, especially those of the Netherlands and Belgium, have much greater capacities than Canadian refineries and, of course, have more concentrated markets compared to Canada's widely dispersed markets. At pages 104 and 105 of Volume III of the Green Books, the Director describes a formula to convert Rotterdam selling prices to crude oil costs in the Middle East and then uses this formula, in his Tables 32 and 33, to portray "Implicit Middle East Prices" for Imperial, Shell, Texaco and Gulf. If this formula were applied to the range of gasoline prices which the Consumers Association of Canada found in its surveys submitted to the Commission in Vancouver, a variance of about 10 percent or \$4 per barrel would be produced in the theoretical well-head price of Canadian crude oil. The Director's

analysis constantly and wrongly assumes that crude oil and product pricing in a competitive market is a cost-plus exercise.

Table 5, following, sets out the variations in the theoretical cost of crude oil at Edmonton estimated from the retail price of regular grade gasoline as reported in surveys conducted by the Consumers Association of Canada:

TABLE 5

Theoretical Variation in the Cost of Crude Oil at Edmonton as Derived from Gasoline Price Data Provided to the Commission by the Consumers Association of Canada at Vancouver (R.T.P.C. Exhibit No. C-93)

	<u>Vancouver</u>	<u>New Westminster</u>	<u>West Vancouver</u>	<u>Richmond</u>
Full Serve Prices per litre reported by CAC in survey area				
Highest	40.8¢	40.9¢	40.9¢	39.9¢
Lowest	38.2	39.2	38.6	39.1
Difference	2.6	1.7	2.3	.8
Difference per bbl.	\$4.13	\$2.70	\$3.66	\$1.27

The basic cost of crude oil at Edmonton in December 1981 was \$21.25 per barrel. While there would be some differences in the cost of the streams moved via pipelines to the Vancouver refineries, the variations would be significantly less than the derived costs shown above.

The use of a series of observed product prices as a method of deriving crude oil prices at their point of origin, appears to offer a low degree of reliability. This method, if applied to the Rotterdam prices discussed elsewhere in this Submission and in the Director's Green Books, should not be expected to provide useable results.

Response to Specific Allegations Concerning Alleged Control

The Director alleges, at Volume III, pages 50-51, that the company "had its crude oil slate and crude prices dictated to it by its parent." As an example, the Director states that "Texaco [Canada] admitted that it used Middle Eastern crude oil in the 1960's because it was told to do so (Document #6710)."⁵¹

It is Texaco Canada's submission that this allegation is false and is not supported by the evidence. With specific reference to the Director's example, Texaco Canada did not use Middle Eastern crude oil in the 1960's because it was "told" to do so by its majority shareholder.

In the closing years of World War II, the company was preparing for a substantial increase in the capacity of its refinery in Montreal and sought the advice of Texaco Inc. with regard to the long-term prospects for crude oil supplies in the post-war period.

Texaco Canada concluded that the Middle East was likely to represent the major source of crude oil in the years to come and that Texaco Inc. could offer reasonable assurances of supplies from this area on a long-term basis at favourable prices.

At this point in time, the substantial petroleum resources which were soon to be discovered in Western Canada had not been found, and Texaco Canada expected to supply its markets in Eastern Canada, and a portion of Western Canada, with products made from imported crude oil.

The company decided to prepare the Montreal refinery for the long-term use of light, high-sulphur crude oil from Saudi Arabia. The initial facilities were provided during the expansion of the plant to 45,000 barrels daily in 1946. Other equipment was added at a later date to produce product of improved specifications and meet other conditions in the marketplace.

Texaco Canada used Middle Eastern crude oil in the 1960's not because it was told to do so by Texaco Inc., as alleged by the Director, but because it had geared its Montreal refinery to run sour crude oils, particularly from Saudi Arabia, based on an informed judgement by Texaco Canada that this would be a financially advantageous and secure source of crude oil for many years to come.

The Director further alleges, at page 51, that "When it suited its parent to change its crude oil slate — as in 1967 and in 1969 — Texaco [Canada] had no say in the matter." Again, this allegation is false and misrepresents the evidence that is before the Director. We shall deal with the situation in the years 1967 and 1969, cited by the Director, in turn.

In 1967 a war caused the closing of the Suez Canal and the shutting down of deliveries, during the months of June, July and August, 1967, through the pipelines which normally carried Middle Eastern crude oils to marine terminals at the eastern end of the Mediterranean. Prior to its closing, about 3½ million barrels a day of crude oil moved through the canal to Europe. Tankers were re-routed around the Cape of Good Hope thereby increasing the turn-around time by approximately three weeks and placing a strain on shipping facilities.

The flow of Arabian crude oil to Texaco Canada was reduced by the global disruptions, but refining operations were not adversely affected since the company's supplier obtained suitable crude oils from other sources to replace the lost volume.

A dispute arose between Texaco Canada and Texaco Inc. regarding the price of Louisiana crude oil — one of the substitutes for Middle Eastern crude oil. The Director alleges, at page 51, that Texaco Canada's crude oil costs "were increased even though, in its own opinion, its contract with its parent should have protected it from any increase (Documents #8503-5, #8494, #8495)." ⁵² Contrary to the Director's conclusion, this was not a case of Texaco Inc. imposing a higher price and a different crude oil slate on Texaco Canada but rather a negotiated resolution of a contractual dispute.

Texaco Canada adopted the position that its crude oil supply contracts entitled it to acquire the substitute Louisiana crude oil at the price for which it had contracted to purchase the Arabian Light and Iranian Light crude oils under the original contracts. In advancing this argument, Texaco Canada recognized throughout that the Louisiana crude oil was of a premium grade of exceptionally high quality. Texaco Inc.'s position was that the force majeure and alternative source clauses did not bind the seller to supply the Louisiana crude oil at the same price as the contracted crude oil slate.

Texaco Canada and Texaco Inc. adopted tenable legal positions in the dispute. Without resorting to arbitration, the parties arrived at an amicable settlement in December of 1967 at a price satisfactory to Texaco Canada and representing a discount of 65 cents per barrel off the posted price.

Significant benefits accrued to Texaco Canada as a result of the supply of Louisiana crude oil. Most importantly, Texaco Canada received an uninterrupted flow of crude oil and none of its customers went short of product during this period.

The company estimated that there was a refining differential of 30 cents per barrel in favour of the Louisiana crude oil over the Arabian, so that the net additional cost of Louisiana crude oil was 35 cents per barrel (Canadian). Since this was associated with only 1.1 million barrels, the disruption due to the Middle East War in 1967 cost Texaco Canada less than \$400,000, certainly much less than would have been the cost had the company been “on its own” during the period.

The Director further alleges that Texaco Canada’s crude oil slate was improperly dictated by its parent in 1969.

The company, in fact, found it necessary to reduce the amount of high sulphur crude oils used in its Montreal plant as a result of new fuel oil specifications issued by the Montreal Urban Community. The company’s supplier agreed to replace Arabian crude oil supplies with crude oils of lower sulphur levels from South American countries. These changes in crude oil supplies are set out in Table 2, above.

Table 6, following, shows the sulphur limitations placed on fuel oils by the Montreal Urban Community.

TABLE 6
Restrictions on Sulphur Content of Fuel Oils
Brought into Force by Montreal Urban Community
Data Represents Maximum Sulphur Content by Weight

	Percent		
	<u>Light</u>	<u>Intermediate</u>	<u>Heavy</u>
Oct. 1, 1970 .....	.6	1.5	2.5
1971 .....	.5	1.25	2.0
1972 .....	.4	1.0	1.5

During this and subsequent years, Texaco Canada called upon its supplier to provide a slate of crude oils which would enable the company to meet the changing product specifications in this particular area without the need for substantial investment in product upgrading facilities.

The fourth and final example used by the Director to illustrate his contention that Texaco Canada had little independence of action was extracted from document #51097.⁵³ The Director states, at page 51, “In 1970, Texaco [Canada] claimed that, even though a reduction in price had been negotiated with its parent, it never received the full amount to which it was entitled (Document #51097).”

The statement to which the Director refers is contained in a memorandum to file containing some twenty points which might be used as negotiating positions relating to the 1971 crude oil contract. The sentence in question, which referred to the 1970 contract prices, ended “. . . the full amount to which *we calculated we were entitled*” (emphasis added). The Director’s misuse of this sentence turns a calculation or opinion used during negotiations into a statement of fact. In truth, the company was satisfied with its 1970 contract, as stated in document #51167.⁵⁴ The author stated that the parties “agreed that the above delivered prices to Portland in the volumes to be designated by Texaco Canada as most desirable for its product requirements, were at a mutually satisfactory commercial value.”

The value referred to in that statement is set out below:

Crude Oil	°API	\$U.S. per Bbl.		
		Actual 1969	Preliminary 1970	Final 1970
Orito	34	\$2.30	\$2.28	\$2.30
Lagomedio	32	2.40	2.26	2.25
Mata	30	2.43	2.29	2.21
Arabian Lt.	34	<u>2.33</u>	<u>2.29</u>	<u>2.28</u>
Simple Average		2.37	2.28	2.26

Furthermore, the company's supplier adjusted the agreed upon slate of crude oils to provide a larger proportion of low sulphur feed stocks needed by Texaco Canada to cope effectively with the increasingly more stringent product specifications in the Montreal area. Arrangements were made to displace some 1¼ million barrels of Orito with Nigerian crude oil.

In Summary:

- Preparations for the use of Arabian crude oil at the Montreal refinery were made 15 to 20 years prior to the date when the Director states Texaco Canada was "told" to use Middle Eastern crude oil.
- The change in the crude oil slate in 1967, which the Director alleges was made without the concurrence of Texaco Canada, resulted from the closing of the Suez Canal and cessation of pipeline shipments to Sidon. The quantity and quality of the replacement crude oil slate was agreed to by the company, and it was able to meet its scheduled crude oil running, product quality and customer commitments throughout the period.
- The so-called increased crude oil cost in 1967 was related to emergency supplies of Louisiana crude oil. This incident was not of significance in Texaco Canada's overall operations, representing in fact less than 1/10 of 1 percent of total operating costs for the year.
- The change of crude oil slate in 1969 was at the request of Texaco Canada when a legislated reduction in the permissible sulphur level in certain products required the refining of a progressively higher proportion of crude oils having a lower sulphur content.
- Texaco Canada considered its crude oil contract for 1970 to be satisfactory.

Response to Specific Allegations Concerning Pricing Policy

TEXACO CANADA'S PRICES IN THE 1960'S

At page 51, the Director states that "Texaco [Canada]'s prices did not decrease as rapidly as world prices." This statement is followed by a comparison of Texaco Canada's decrease of 42 cents per barrel on Arabian crude oil and the allegedly comparable decrease of 58 cents per barrel on the FOB price of selected Arabian crude oils imported into the United States.

This data was drawn from document #6640,⁵⁵ the second page of a memorandum dated September 3, 1964. The author of the document stated that the company's price of Arabian crude oil was reduced 42 cents per barrel between 1957 and 1961. While this reduction was described as "FOB Montreal", it related in fact to the CIF (cost, insurance, freight or delivered prices) prices at Portland which, according to the contracts in effect at the beginning of 1958 and the end of 1961, were \$3.00 and \$2.58 per barrel respectively. Therefore, the author of the internal

Texaco Canada memorandum was in error in referring to the price reduction as relating to the company's FOB price for Arabian crude oil. Accordingly, the Green Books are inaccurate to the extent that they rely upon this original error.

The information contained in document #6640 was then compared to allegedly similar data derived from company document #57714.⁵⁶ This document contained data from the U.S. Bureau of Census, Department of Commerce which indicated that the average prices of Arabian crude oils above 25° API imported into the United States during the calendar years 1958 and 1962 were \$2.49 and \$1.91 per barrel respectively, representing a decrease of 58 cents.

The data contained in documents #6640 and #57714 was not directly comparable. This is so for several reasons, as set forth below:

- The time period is not identical.

The Texaco Canada price of \$2.58 per barrel at the end of 1961 prevailed for the first seven months of 1962 when it was reduced to \$2.43 per barrel. This resulted in an average contract price of \$2.51 per barrel for the year 1962, representing a decrease of 49 cents per barrel rather than the 42 cents attributed.

- The U.S. data did not relate to the same grade of crude oil.

The U.S. Bureau of Census data included all Arabian crude oils of 25° API gravity and above whereas Texaco Canada used only Arabian Light of 34° API. Accordingly, the Director should not be equating crudes of obviously different value.

- The U.S. data included loadings at two ports with different prices.

The U.S. Bureau of Census data included loadings at Ras Tanura and Sidon. Texaco Canada loaded at Sidon where the posting was 37 cents per barrel higher than that at Ras Tanura, reflecting the pipeline transportation differential of 37 cents per barrel.

The combined effect of the non-comparability of the grades and the difference in prices at the loading ports — all in undisclosed ratios — disqualifies the use of the U.S. data in any direct comparison to the Texaco Canada data.

As further evidence of the non-comparability of the data, according to the U.S. Bureau of Census the cost of imports into the United States of Iranian crude oil — closely related in price to Arabian crude — decreased only 24 cents per barrel during the years 1958-1962.

By importing a larger proportion of the heavier grades of Arabian crude oil in the early 1960's, U.S. refiners were better able to meet the rapidly increasing demand for residual fuel oils. This may have been one of the reasons for the decrease in the average price of imported Arabian crude oil. The light grade decreased by only 28 cents per barrel, not 58 cents.

If the assumption is made that one third of the Arabian crude oil entering the United States in 1962 consisted of loadings at Ras Tanura instead of Sidon (which appeared to be the exclusive port of loading in 1958), or that one third of the stream in 1962 consisted of heavy crude oil, an arithmetical average of \$1.91 per barrel is produced — matching the reported average price.

Further evidence of the invalidity of the Director's comparison may be drawn from data published by the Saudi Arabian Monetary Agency and quoted in the *Oil and Gas Journal*, January 20, 1964. This data indicates that the average price of crude oil exported by Aramco, then the sole agency through which exports from Saudi Arabia were made, decreased by approximately 35 cents per barrel between 1958 and 1962.

Table 7, following, sets out, in chart form for ease of reference, the data discussed in the preceding paragraphs. The table contains posted and import prices of the various crude oils mentioned.

TABLE 7

**Posted Prices of Arabian and Iranian Crude Oils
Compared to the Combined Imports into the United States**

		\$U.S. per barrel			
	<u>°API</u>	<u>1958</u>	<u>1960</u>	<u>1962</u>	<u>Decrease 1958 to 1962</u>
Arabian Crude Oil					
Posted FOB Ras Tanura					
Light	34°	\$2.08	\$1.80	\$1.80	\$0.28
Medium	31°	—	1.59	1.59	—
Heavy	27°	1.65	1.47	1.47	0.18
Posted FOB Sidon Light		2.45	2.17	2.17	0.28
Iranian Crude Oil					
Posted FOB Abadan Light	34°	1.99	1.81	1.73	0.26
Medium	31°	1.80	1.62	1.58	0.22
Entering United States					
Arabian	Unknown	2.49	2.12	1.91	0.58
Iranian	Unknown	1.98	1.74	1.74	0.24

FREIGHT CHARGES IN THE 1960's

The Director also asserts that the decline in the average AFRA freight from Sidon to Portland should be added to the apparent decline in imports entering the United States to arrive at a price against which Texaco Canada's CIF prices at Portland may be measured. This approach should be rejected because of the inaccuracy of the price analysis of U.S. imports.

Texaco Canada's estimate of the decrease in AFRA freight as noted in document #57548,⁵⁷ dated June 18, 1964, was 30.3 cents per barrel. The company now believes that the average freight from Sidon to Portland in 1958 was 95 cents compared to 59 cents in 1962, a decrease of 36 cents per barrel.

If this apparent decrease in freight were added to the decrease in the posted FOB price of Arabian and Iranian crude oils of 34° API gravity, totals of 64 cents and 62 cents per barrel respectively would be generated.

While the decrease in the company's cost of Arabian crude oil delivered to Portland amounted to 49 cents per barrel based on the average cost in 1962 compared to 1958, a total reduction of 57 cents per barrel was achieved in the latter half of the year when a further reduction of 15 cents per barrel went into effect on August 1, 1962.

WERE TEXACO CANADA'S PRICES COMPETITIVE?

The Director alleges, at pages 52-53, that Texaco Canada paid more for its crude oil supplies than its competitors. Documents #6641,⁵⁸ 6642,⁵⁹ 6701⁶⁰ and 6711⁶¹ are relied upon in support of this contention. No competition issue is demonstrated because nowhere is it suggested that Texaco Canada dominated the market or dictated market prices. However, Texaco Canada rejects the allegations and makes the following written submissions by way of response.

- The Director alleges, at page 52, that Texaco Canada's crude oil prices were higher than those of its major competitors, citing an instance in 1959 in which "Texaco [Canada] estimated that its crude oil costs were 12¢ per barrel higher than the average of its 'competitors' in Montreal (Document #6641)."

The Green Books omit to point out that, during its negotiations in 1959 in respect of the 1960 crude oil contract, Texaco Canada sought a reduction of 12¢ per barrel on its purchases of 15 million barrels of Arabian crude oil. This was equivalent to 1.8 million dollars in annual costs.

Its supplier agreed to the reduction in total but offered a decrease of 8 cents per barrel on Arabian and 10 cents per barrel on Venezuelan. This offer was accepted by Texaco Canada. The price of Arabian in the 1960 contract was reduced to \$2.68 per barrel CIF Portland, from \$2.76. The Venezuelan contract price was reduced to \$2.43 per barrel FOB loading port, from \$2.53.

Therefore, it is quite clear that, contrary to the Director's implication, Texaco Canada negotiated a significant reduction in its crude oil costs for the year 1960.

- During its negotiations in October, 1960 for crude oil supplies for 1961, the company sought to use a public statement made by Imperial Oil (as reported in document #6642) which suggested that the price of gasoline in Quebec might rise by as much as 5 cents per gallon if Canadian crude oil were to displace imported crude oil.

From this scanty information it was concluded that Imperial Oil then had a crude oil cost advantage over Texaco Canada of 35 cents per barrel. Texaco Canada did not know what assumptions had been made with respect to transportation of the crude oil from Alberta, sales and other taxes, if any, and dealer margins, nor was the company aware of the method used to allocate the increased cost of feed-stocks to individual products. The company's negotiator also concluded that one of the five cents might have been an exaggeration factor.

The estimate of 35 cents was not a meaningful figure but was used, nevertheless, during negotiations for supplies in 1961. This incident also tends to disprove the Director's consistent allegation of harmonization among the major oil companies in Canada. The best competitive information that Texaco Canada was able to obtain at that time in respect of crude oil supplies was a public statement made by Imperial Oil, and Texaco Canada had no knowledge of the assumptions upon which that statement was based. If the majors harmonized to the extent alleged by the Director, one would expect that the company would base its pricing decisions on more reliable information than an inconclusive public statement.

During these same negotiations in respect of the company's 1961 crude oil contract, its negotiator contended, in document #6642, that a loss of 20 cents per barrel resulting from large volume, high-discount commercial and industrial business in the Montreal area, warranted a reduction in Texaco Canada's costs of crude oil.

Again during the 1961 negotiations, Texaco Canada learned of a discount of 30 cents per barrel said to have been offered to Canadian Oil Companies Limited for the purchase of an undisclosed volume of light Iranian crude oil. Reference to this was made in document #6642.

At the time, Canadian Oil was asking about a supply of products from Texaco Canada in Quebec and mentioned the unconfirmed price information during the course of its negotiations. A supply agreement was not reached. Texaco Canada subsequently used the information in its own negotiations with its crude oil supplier.

- At pages 52-53, the Director relies on document #6701 in support of his statement that Texaco Canada “calculated that the average discount was 33.5¢ per barrel on Venezuelan crude that was being received by its Montreal ‘competitors’ . . . while it was receiving discounts of only 27¢ per barrel at this time”. Texaco Canada submits that this statement is inaccurate as the Director again fails to recognize the difference between statements of fact and negotiating positions.

In 1964, the company estimated, in document #6701, that the refineries in Montreal were obtaining a range of Venezuelan crude oils of about 31° API gravity at an average price FOB loading port of \$2.23 per barrel.

At the same time Texaco Canada was obtaining Mata crude oil of about 30° API gravity at a price of \$2.22 per barrel FOB loading port.

WERE TEXACO CANADA’S FREIGHT COSTS COMPETITIVE?

At page 53, the Director states that Texaco Canada “suffered” from uncompetitive freight rates in the Venezuela to Portland route during the mid-1960’s. Documents #6703,⁶² 6706⁶³ and 6685⁶⁴ are quoted in support of this statement.

The transportation of crude oil from Venezuela to Portland in the period 1958 through 1968 was carried out mainly in vessels which were obtained by direct negotiations between Texaco Canada and third parties.

The company chartered five vessels of 14,000-18,000 deadweight tons in the late 1940’s for use in the Caribbean-to-Portland or Montreal trade. It also inherited, through its acquisition of Regent Refining in 1956, a contract of affreightment which was intended to provide transportation of crude oil from the Caribbean to its Ontario refinery at Port Credit.

In addition, the company negotiated a 5-year contract of affreightment with Texaco Panama, commencing in 1964, in which that company matched a new-building offer obtained by Texaco Canada from a third party not associated with Texaco Inc.

The agreements which were negotiated and entered into by Texaco Canada were considered to be at rates and under conditions which were in the best interests of the company’s shareholders. In retrospect, Texaco Canada would have benefitted financially if it had entered into AFRA rate contracts using vessels owned by its majority shareholder.

Before the last of its above mentioned freight contracts expired in 1968, Texaco Canada recognized that vessels of greater carrying capacity and hence lower operating costs constituted a rapidly growing segment of the world’s tanker fleet. The vessels involved in the agreements were unsuited to the long-haul traffic in Middle Eastern crude oil to which the company was

substantially committed as a result of its decision in the mid-1940's to use Arabian crude oil in its Montreal refinery. As well, the small number of vessels did not provide sufficient flexibility in the scheduling of loadings and unloadings. Such scheduling requires the co-ordination of: vessel availability, space at the Portland, Maine terminal dock, entry to the pipeline, storage capacity at the refinery and the daily rate of consumption at the plant.

In summary, then, it is Texaco Canada's submission that the Director was wrong in ignoring the results of arms-length freight contracts in his calculations of derived FOB crude oil costs.

TEXACO CANADA'S CRUDE OIL COSTS IN THE MID-1960'S

Based on his views on pricing and his erroneous assumptions with respect to transportation of Venezuelan crude oil during the mid-1960's, the Director also asserts, at page 53, that Texaco Canada's competitive disadvantage continued beyond the 1964 time frame of the quoted documents.

Documents #6703,⁶⁵ 6710⁶⁶ and 6711,⁶⁷ all of which were part of a memorandum prepared for use in negotiating the 1965 crude oil contract, are used to support the allegation.

The Director's assertion is wrong for the reasons set out below:

- The company's average cost of \$2.78 per barrel for crude oil delivered to Montreal in 1964 was compared to a reported cost of \$2.30 for a crude oil from which product (butane) could be extracted in competition with butane supplied from Western Canada.

The difference of 48 cents per barrel (45 cents in U.S. funds) is alleged by the Director to be a measure of Texaco Canada's competitive disadvantage.

It is Texaco Canada's submission that a price of crude oil derived from the price of butane does not provide any credible evidence of the real value of the crude oil.

- Texaco Canada again endeavoured to use information about an alleged price discount of 35 cents per barrel to another competitor as part of its bargaining strategy recorded in the 1964 memorandum. The seemingly decisive information about discount was clouded, however, by lack of knowledge concerning the freight component; thus, the final delivered cost was placed in doubt.

Again, this information was not sufficiently positive to exert any significant influence upon the prices agreed to for Texaco Canada's supplies in 1965. Furthermore, the discount was associated with Iranian crude oil which Texaco Canada had not purchased since 1962.

- These comments by the Director, at page 53, are apparently intended to indicate that one of Texaco Canada's concerns during this time period was related to freight. In fact, the company made its own arrangements for freight from Venezuela to Portland for most of the years under discussion.

It is manifestly unfair to judge, with the advantage of hindsight, the decision reached by Texaco Canada concerning the freight agreements entered into — more particularly so when blame is laid at the doorstep at Texaco Inc.

Texaco Canada has long accepted the principle of using the Average Freight Rate Assessment ("AFRA") to represent a reasonable measure of freight over an extended period of time. AFRA reflects the moving average of arms-length agreements between buyers and sellers on a world-wide basis, and is a widely accepted standard.

AFRA rates reflect the longer term market trends rather than the day-to-day volatility of spot charters.

Company management and responsible tax and other governmental authorities in Canada and abroad continue to regard AFRA rates as a reasonable bench mark for determining acceptable levels of transportation charges for the world-wide movement of crude oil and refined petroleum.

Texaco Canada accepts and relies on the AFRA freight rate analysis presented by Imperial Oil Limited in Part IV of its Second Submission to the Restrictive Trade Practices Commission on the State of Competitive in the Canadian Petroleum Industry, International Linkages — Canada and the World Petroleum Market 1958-1982.

The company's computed AFRA freight in document #6711 was 43 cents per barrel, the use of which reflected a discount of 17 cents per barrel in the FOB price of Arabian crude oil at Sidon. It was this 17 cents, rather than the 10 cents erroneously used by one of the company's crude oil analysts, which should have been deducted from the reported but unconfirmed discount of 35 cents on Iranian crude oil to arrive at a differential of 18 cents instead of 25 cents. This differential must be further reduced by 10 cents representing the company's best judgment of the refining differential between the two crude oils in that particular year.

Texaco Canada's cost of Arabian crude oil at Portland during 1965 averaged \$2.33 U.S. per barrel, a decrease of 10 cents per barrel from the average for 1964.

Historically, about 15 to 20 percent of the company's sales volume has been "bid" business, often at marginal prices. During most of the years when the negotiator used the product price-crude oil relationship strategy to seek lower prices and, accordingly, recorded such information as could be gleaned, the company's marketing arm succeeded in maintaining or increasing its sales volume at prices acceptable to customers, and competitive in the market. These sales satisfied the company's policy of refusing to sell at prices which were below marginal cost.

Although crude oil costs do not necessarily bear a direct relation to the price of petroleum products (competition determines prices), Texaco Canada's success and profitability in a market in which imported products were plentiful is further evidence that it had not paid artificially high crude oil prices.

The quotation used by the Director, at page 54, to imply that the degree of control exercised over Texaco Canada was "not in doubt" and that the effect of that control over product prices was "of interest" is taken out of context. The representative of the company's crude oil supplier is reported as having said "Well you don't have to bid at a loss, we don't, just pass it up" (document #6727).⁶⁸ To attribute this statement as an "instruction" is another indication of the lack of understanding of the negotiating memoranda and the remarks, comments and analyses contained therein, as well as of the relationship between the company and its major shareholder.

Neither of the individuals engaged in the crude oil price negotiations was aware on a day-to-day basis of the prices at which products were marketed. Moreover, the author of document #6727 played no role in the product pricing decisions of the company's Marketing Department.

At page 54, the Director states that "During the last half of the 1960's, Texaco [Canada]'s competitive disadvantage continued since its crude oil prices were frozen as world prices generally continued to fall". The Director goes on, at pages 54-55, to contend that Texaco

Canada used comparisons of average prices of its ‘competitors’ “. . . in order to delineate its true disadvantage”.

On the contrary, Texaco Canada’s basic cost of crude oil decreased by about 10 cents per barrel from the level of \$2.56 in 1964 to \$2.46 in 1969.

During this same period, the company’s estimated pre-tax margin of profit from its refining and marketing operations, prior to the allocation of corporate overhead charges, showed an improvement of about 11 cents per barrel.

In view of the fact that the company’s estimated pre-tax margins in the downstream sector increased during this period, the Director is wrong when he states, at page 54, that “. . . Texaco [Canada]’s competitive *disadvantage continued . . .*” (emphasis added). Moreover, the Director’s own allegations concerning comparisons of Texaco Canada’s prices with those of its competitors refute any suggestion of harmonization between the majors.

The allegation of Texaco Canada’s continuing competitive disadvantage is not consistent with the Director’s own data concerning the postings of key crude oils in the Middle East and Venezuela which showed no change from 1964 through 1969. Nor is the statement supported by the data that the Director claims as “third party or arm’s length prices”. These prices, as shown in Table 8, following, indicate a decrease of about 10-12 cents per barrel in Middle Eastern crude oils and an increase of 7 cents per barrel in Venezuelan during this same period.

TABLE 8

Texaco Canada

Changes in the Landed Cost of Imported Crude Oils Compared to Changes in the Posted and “Third-Party” Prices of Selected Crude Oils Referred to by the Director in Volume III

A. Texaco Canada	\$U.S. Per Barrel		
	1964	1969	Change
Landed Cost at Refineries			
Middle East	\$2.58 (12%)	2.43 (33%)	– 0.15
Venezuela	2.56 (85%)	2.49 (56%)	– 0.07
Other	2.35 (3%)	2.40 (11%)	+ 0.05
Weighted Average	2.56 (100%)	2.46 (100%)	– 0.10
B. Prices Claimed by Director as “Third Party” p. 148, Table C-1			
Light Arabian 32-34°	1.30 – 1.42	1.23 – 1.30	– 0.10
Light Iranian 34°	1.29 – 1.34	1.20	– 0.12
Lagomedio 32°	1.63	1.70	+ 0.07
Simple Average	1.44	1.39	– 0.05
C. Posted Prices Listed by Director p. 152, Table D-1			
Light Arabian 34°	1.80	1.80	N/C
Kuwait 31°	1.59	1.59	N/C
Venezuelan 35°	2.80	2.80	N/C
Simple Average	2.06	2.06	

TEXACO CANADA'S CRUDE OIL COSTS IN THE 1970'S

At page 55, the Director refers to document #53897⁶⁹ and states that “In 1970, Texaco [Canada] was granted a reduction in its crude oil costs, a reduction that would have left it 8¢ above the average 1968 cost of crude incurred by its ‘competitors’ . . .”. It is then alleged, based on document #51097,⁷⁰ that Texaco Canada’s crude oil costs “. . . remained about 9¢ per barrel above the average of the other companies . . .”. At this point the Director makes the serious allegation that “. . . with the reversal in the world market conditions in 1970, its parent reneged on part of the promised price reduction”. Texaco Canada submits that these allegations are unfounded.

As a result of negotiations, the landed cost of the slate of crude oils used in the Montreal and Halifax refineries in 1970 in \$U.S. per barrel averaged \$2.40 compared to \$2.46 in 1969, a reduction of 6 cents.

Prices and other conditions for 1970 crude oil supplies were satisfactory to Texaco Canada (document #51182⁷¹ or #53907⁷²). Prices for all crude oils were established at the levels requested by the company, with the exception of 30° API Venezuelan for which an additional reduction of 4 cents per barrel was voluntarily provided by Texaco Inc. (document #51097).

Texaco Inc. did not “renege on part of the proposed reduction”. The Director has consistently misinterpreted statements contained in the memoranda which were prepared as the basis for negotiating crude oil supplies and prices. For example, the Director’s statement that Texaco Inc. had “reneged” was apparently based on one sentence in paragraph 13 (document #51097) “. . . we did not obtain the full amount of the reduction to which we *calculated* we were entitled for the year 1970” (emphasis added). Neither Texaco Canada nor its supplier succeeded on all occasions during the bargaining process in obtaining prices and conditions to which each felt it was “entitled”. When an agreement was reached, both parties carried out their obligations.

In the example given by the Director, there was no obligation on the part of Texaco Inc. to meet all the terms and conditions to which Texaco Canada “calculated” it was entitled, and it is improper for the Director to state that Texaco Inc. “reneged” when it had not agreed to the matter in the first place.

At pages 56-57, the Director alleges that during the period 1971 through 1973, “The parent demanded that Texaco [Canada] now pay the open-market price (Document #51096)⁷³ — a position entirely different from that adopted during the 1960’s when market prices were falling. Subsequently, the parent Texaco company incorporated ‘market strength’ increases into the price increases demanded of its Canadian subsidiary”. The Director goes on to state, based on document #50061,⁷⁴ that these increases “were out of line with the prices which would be expected from applying increases in freight and government take over the past year”. The Director developed Table 15, at page 57, to illustrate his contention that these demands were successful.

In 1971 and the years immediately following, Texaco Inc., as part of its bargaining strategy, requested that Texaco Canada purchase its crude oil at prices which reflected “market strength”. This term was defined in document #50061 as the approximate mean between the high and low of the auctioned crude oil, both royalty and participation.

Crude oil producing countries exerted pressure to increase their revenue from the sale of oil, and price changes occurred with greater frequency as the host government take (“HGT”) increased. Between 1970 and early 1973 for example, the HGT from light grades of crude oil

increased by 74 cents per barrel in Venezuela and 69 cents per barrel in Saudi Arabia according to the data used in the Director's Table 15, page 57.

The Director then matched these increases against the increases in Texaco Canada's CIF prices at Portland. These CIF prices, however, reflected changes in the freight component as well as at the HGT, thus distorting the comparison and leading to an incorrect assumption.

The Director found that while the HGT in Venezuela increased 74 cents per barrel from 1970 to early 1973, Texaco Canada's price rose 76½ cents resulting in an apparent difference of 2½ cents. The freight component increased 2 cents, leaving a net difference of ½ cent between Texaco Canada's cost increase and the increase the Director found in HGT.

Similarly, the HGT in Saudi Arabia was found to have increased 69 cents while Texaco Canada's price rose 79½ cents — a difference of 10½ cents. The freight component increased 8 cents, resulting in a net difference of 2½ cents.

These differences are insignificant and may well be a more accurate reflection of the effects of HGT than the dozen bits of information, all rounded to the nearest whole cent, which the Director used for this meaningless comparison.

Details of the foregoing analysis may be found in Exhibit 1, appended to this Submission.

The thrust of the Director's assertions in respect to the prices paid by Texaco Canada for its crude oil supplies and contained in the section entitled "(b) Price History", from pages 51 through 57, is a claim of overpayment.

WHAT WAS FAIR MARKET PRICE?

The Director has not established that Texaco Canada paid any more for its long term crude supplies and freight than market conditions warranted. Indeed, he does not seem to have attempted to prove that the Canadian market or Canadian consumer suffered any disadvantage by reference to any other world market. This submission is made for the following reasons:

- The Director has advanced no evidence of any viable alternative source of supply for its crude oil requirements to which the company could have turned throughout the period.
- Petroleum product prices, exclusive of direct taxes and levies, were no higher in Canada than in other countries.
- The value of crude oil in world markets is reflected in the prices at which 80 to 90 percent of the free world's demand of 50 million barrels per day is transacted.
- Prices associated with spot, short-term or small volume are the result of short term imbalances which develop independently of long term trends and values.
- Crude oil provided much of the free world's energy and Canada's import requirements were a very small percentage of the total trade.

(iv) Prices Paid for Crude Oil

Texaco Canada's Special Crude Oil Requirements

When arranging for the purchase of imported crude oils each year, Texaco Canada gave due consideration to quantity, quality, price and security of supply. Selection of the oils which comprised the slate reflected the operating limitations of the refineries and the prevailing

standards of product quality and marketing strategies. This procedure prevailed before, during and after the time period which was examined by the Director.

Imported crude oil has been used exclusively at the Halifax refinery since 1964 except for a small amount of domestic crude oil moved to that location via Vancouver and the Panama Canal during 1974 and, more recently, an increasing proportion transported by lake tankers from the Interprovincial Pipeline terminus at Montreal. Imported crude oil was used exclusively at Montreal refinery up to 1973 when domestic supplies formed an increasingly greater proportion of the crude oil slate. A small amount of crude oil was imported into the Port Credit refinery until 1961 when its use was discontinued in favour of domestic crude oil as the company voluntarily complied with the intent of the National Oil Policy introduced in that year.

From the streams of domestic crude oils, the company selected those types which best suited its requirements in those refineries for which domestic grades constituted a significant portion of the crude oil runs.

Domestic crude oil has been used exclusively in the company's refineries at Edmonton since 1952, at Port Credit since 1961 and at Nanticoke since 1978.

During the Toronto Hearings in May, 1975, Texaco Canada supplied the Director with a statement of the quantity received and the landed cost of various crude oils imported by the company, for the years 1956 through 1974. This data was identified by Texaco Canada as a summary of its Form R-1201 and by the Restrictive Trade Practices Commission as Exhibit No. T-17.⁷⁵

Texaco Canada has re-constructed Column Nos. I and V of Table B-1 to adjust for costs of which the Director was unaware, including significant differences in such items as transit losses, °API gravity, \$U.S. exchange rates and direct deliveries to Montreal or St. Romuald. This reconstruction is set out as Table 9, following.

The Director employed the data as the basis for construction of Table B-1, page 139 "Texaco Implicit FOB prices on Middle Eastern and Venezuelan Crudes".

The request for information for the Toronto Hearings did not seek to ascertain the actual °API gravity of the crude oils nor to determine if there were unusual circumstances which might affect the landed cost.

TABLE 9

Landed Cost of Crude Oils Adjusted for °API Gravity, Transit Losses and U.S. Dollar Exchange Rates and other Costs to Correct Data used by the Director in Table B-1

	\$U.S. per Barrel					
	Arabian Light 34°			Venezuelan (Mata 30°)		
	Director's Column I	Adjust- ments	Corrected Column I	Director's Column V	Adjust- ments	Corrected Column V
1958.....	\$3.12	—	\$3.12	\$3.31	\$(.09)	\$3.22
59.....	2.94	(.01)	2.93	3.08	(.03)	3.05
1960.....	2.84	(.04)	2.80	2.93	(.02)	2.91
61.....	2.78	(.07)	2.71	2.95	(.08)	2.87
62.....	2.68	(.05)	2.63	2.86	(.02)	2.84
63.....	2.57	(.02)	2.55	2.67	—	2.67
64.....	2.58	(.03)	2.55	2.63	(.04)	2.59
65.....	2.48	(.03)	2.45	2.57	—	2.57
66.....	2.47	(.03)	2.44	2.54	(.03)	2.51
67.....	2.46	(.02)	2.44	2.57	(.06)	2.51
68.....	2.48	(.05)	2.43	2.53	(.03)	2.50
69.....	2.44	(.01)	2.43	2.51	(.03)	2.48
1970.....	2.34	.04	2.38	2.29	.02	2.31
71.....	3.03	(.01)	3.02	2.85	(.02)	2.83
72.....	3.05	(.01)	3.04	2.94	.14	3.08
73.....	3.57	(.19)	3.38	6.16	(1.79)	4.37

Details of the adjustments in Table 9 may be found in Exhibit 2 and Exhibit 3, appended to this Submission.

Tables 10 and 11, following, constitute together a re-statement of the Director's Table B-1, 1958 through 1973, incorporating the adjustments to landed costs as shown in Table 9, above, and the substitution of Texaco Canada's actual cost of freight from the Caribbean for that which the Director assumed was not arms-length. The Director wrongly disregarded Texaco Canada's actual out-of-pocket freight costs associated with the supply of Venezuelan crude oil up to and including 1968. Data derived from Tables 10 and 11 have been superimposed on Charts 1 and 2, following, using Figures IX-14 and IX-9 contained in the Second Submission of Imperial Oil Limited to the Restrictive Trade Practices Commission.

In addition to correction of the basic data, Texaco Canada does not accept the validity of the derived FOB price of the Venezuelan crude oil from 1960 through 1968. During these years, the company's transportation of crude oil from the Caribbean to Portland, Halifax or Montreal was in vessels whose charters or contracts of affreightment were the result of third-party or arms-length agreements entered into by Texaco Canada.

TABLE 10

Texaco Canada's Re-Statement of Director's Table B-1 (III p. 139)

Arabian Crude Oil (34°)

Derived Price FOB Ras Tanura, using Average AFRA Freight with a Comparison of Such Data to the Official OPEC Price

\$U.S./BBL.

Year	Landed Cost Montreal Refinery	Portland Pipeline Tariff (1)	Freight & Loss			Loss Allowance ½ of 1%	Derived Price FOB Ras Tanura (4)	Official Price Arabian Ras Tanura (5)	Apparent Discount Below Official Price
			Landed Cost Portland (2)	Average AFRA Freight (3)	Apparent Pipeline Tariff (3)				
1958.....	3.12	.12	3.00	.95	.37	.02	1.66	N/A	
1959.....	2.93	.12	2.81	.75	.37	.01	1.68	N/A	
1960.....	2.80	.12	2.68	.64	.37	.01	1.66	1.86	.20
1961.....	2.71	.12	2.59	.61	.37	.01	1.60	1.80	.20
1962.....	2.63	.12	2.51	.59	.37	.01	1.54	1.80	.26
1963.....	2.55	.12	2.43	.55	.37	.01	1.50	1.80	.30
1964.....	2.55	.12	2.43	.49	.37	.01	1.56	1.80	.34
1965.....	2.45	.12	2.33	.43	.37	.01	1.52	1.66	.14
1966.....	2.44	.11	2.33	.42	.37	.01	1.53	1.53	—
1967.....	2.44	.11	2.33	.50	.37	.01	1.45	1.50	.05
1968.....	2.43	.10	2.33	.94		.01	1.38	1.45	.07
1969.....	2.43	.10	2.33	.83		.01	1.49	1.40	(.09)
1970.....	2.38	.10	2.28	1.07		.01	1.20	1.35	.15
1971.....	3.02	.11	2.91	1.28		.02	1.61	1.75	.14
1972.....	3.04	.11	2.93	1.09		.02	1.82	1.90	.08
1973.....	3.38	.11	3.27	1.53		.02	1.72	2.64	.92

NOTES:

(1) Portland Pipeline tariff 1958-1962 included transit loss charge of ½ of 1 percent.

(2) Weighted average of contract prices.

(3) Loadings 1958-1967 were ex Sidon because the combined tanker and apparent pipeline freight was cheaper than direct shipment from Ras Tanura via Suez.

(4) Derived price — "Landed Cost Montreal Refinery" minus "Freight and Loss".

(5) Official prices as per Petroleum Intelligence Weekly, p. 11, April 12, 1982.

N/A — not available

TABLE 11

Texaco Canada's Re-Statement of Director's Table B-1 (III p. 139)

Venezuelan Crude Oil (Mata 30°)

Actual FOB Price plus actual Third-Party or Equivalent Freight
(1958-1969) and Derived FOB Price using AFRA Freight (1970-1973)
with a Comparison of Such Data to the Posted Prices

\$U.S./BBL.

Year	Landed Cost Montreal Refinery (1)	Portland Pipeline Tariff (2)	Freight & Loss			Derived Price For Venezuela (3)	Contract F.O.B. Venezuela 30° API	Price C.I.F. Portland 30° API	Posted Prices F.O.B. Venezuela (4)	Actual Discount Below Posting
			Landed Cost Portland	Actual Freight Paid	Loss Allowance ½% of 1%					
1958....	3.22	.12	3.10	.26	.02	—	2.82	—	2.82	NIL
1959....	3.05	.12	2.93	.29	.01	—	2.63	—	2.63	NIL
1960....	2.91	.12	2.79	.35	.01	—	2.43	—	2.53	.10
1961....	2.87	.12	2.75	.31	.01	—	2.43	—	2.53	.10
1962....	2.84	.12	2.72	.33	.01	—	2.38	—	2.53	.15
1963....	2.67	.12	2.55	.26	.01	—	2.28	—	2.53	.25
1964....	2.59	.12	2.47	.24	.01	—	2.22	—	2.53	.31
1965....	2.57	.12	2.45	.26	.01	—	2.18	—	2.53	.35
1966....	2.51	.11	2.40	.21	.01	—	2.18	—	2.53	.35
1967....	2.51	.11	2.40	.21	.01	—	2.18	—	2.53	.35
1968....	2.50	.10	2.40	.21	.01	—	2.18	—	2.53	.35
1969....	2.48	.10	2.38	.19	.01	—	2.18	—	2.53	.35
1970....	2.31	.10	2.21	—	.25	1.95	—	2.21	2.53	.58
1971....	2.83	.11	2.72	—	.29	2.42	—	2.72	2.53	.11
1972....	3.08	.11	2.97	—	.26	2.69	—	2.97		
1973....	4.37	.11	4.26	—	.35	3.89		4.26		

NOTES:

- (1) Mata 30° crude oil was not purchased in 1972 or 1973. Data provided is for Lagomedio adjusted to 30° API gravity.
- (2) Portland Pipeline tariff 1958-1962 included transit loss charge of ½ of 1 percent.
- (3) Crude oil was purchased on CIF basis 1970-1973 and the derived price shown for these years was obtained by deducting regular AFRA freight for LR-1 vessels from the CIF contract price.
- (4) Posting of prices discontinued after 1971.

CHART 1

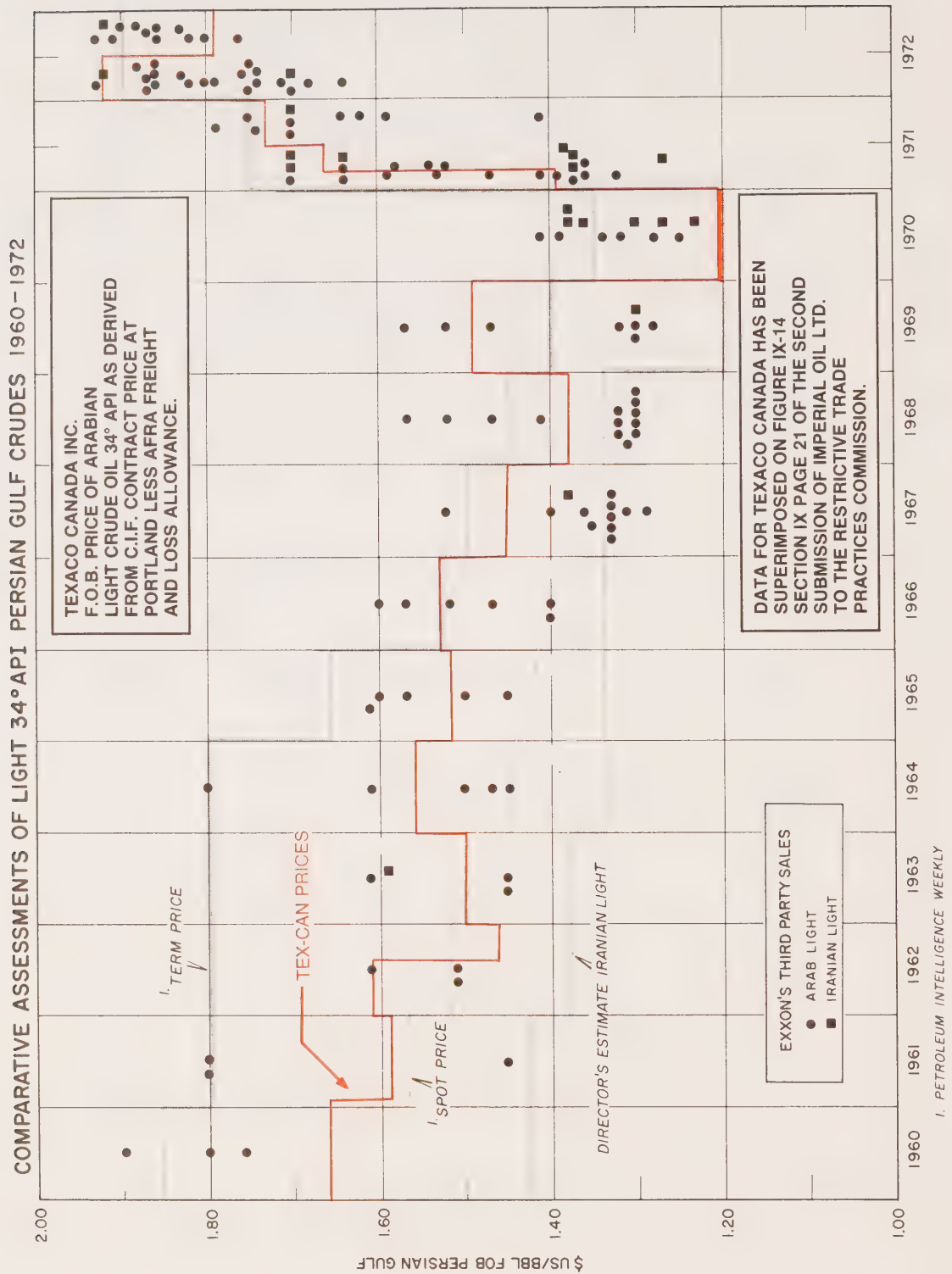
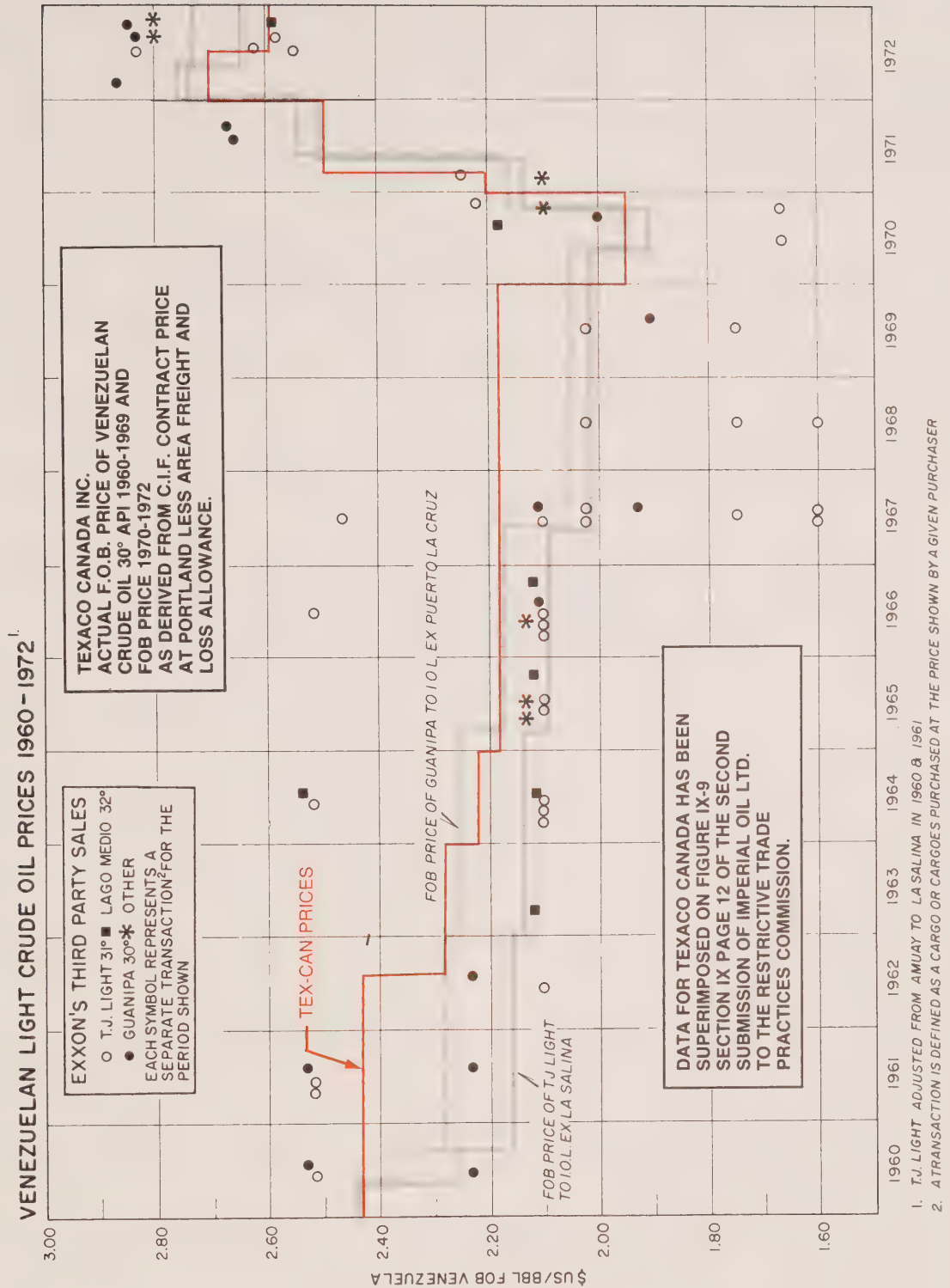


CHART 2



The Sun Document

In the nine year period, 1962-1970, which formed the basis for the calculation, Texaco Canada was said to have paid from about 25 cents to about \$1.00 per barrel more than the reference “price” which the Director selected from document #83927⁷⁶ seized from Sun Oil.

This document identified the series of numbers as “values” in the heading and “Rate of return calculations” in the footnote but did not mention “prices”. The Director apparently assumed the data to represent dollars and cents per barrel although there is nothing to verify this assumption and it might well be construed to mean “percentage” especially when the footnote specifies “Rate of return *calculations*” (emphasis added).

The document did not identify the quality, quantity or location of the substance nor indicate what assumptions were made and how the calculations were performed.

Texaco Canada would not have risked investing a single dollar on the basis of such imprecise information, yet the Director did not hesitate to use this flimsy evidence to accuse the company of being a participant in the \$12-billion over-charge “rip-off” of Canadians.

The Director's Overpayment Calculation

In addition to the uncertainties inherent in the Director's reference “price”, other steps in the calculations are based on certain assumptions with which Texaco Canada is not in agreement:

- The Director's measurement of “over-payment” was based on the company's cost of Venezuelan crude oil compared to the Director's selected reference price. The difference was then applied to all of the crude oil imported by the company, despite the fact that more than one-half of the amount used by the company was from the Middle East.
- The assessment of “over-payment” also involved the use of information gathered from the company and used by the Director without due regard for certain adjustments which were needed to make the raw data conform to the standards of measurement employed in the calculations.

Corrections were required to bring the crude oil to the uniform gravity used by the Director, to reflect U.S. dollar exchange rates which did not correspond to the average annual rates depicted in Table B-7 and to allow for transit losses and other measurable differences which were ignored by the Director.

Texaco Canada believes that the prices which it paid for crude oil supplies, from either Middle Eastern or South American countries, reflected normal transactions between buyer and seller at commercially acceptable levels.

The company's supplier presumably made sufficient profit on the transaction to recover some portion of its “sunk” costs and generated enough cash flow to continue exploring for more oil; Texaco Canada, a relatively small buyer of crude oil on the world markets, had the advantages of obtaining supplies — best suited to its own operations — from a wide variety of sources with great flexibility of transportation and a security of supply which might be expected to accrue to only large purchasers.

The landed cost of Venezuelan crude oil supplies in the years 1962 through 1970 formed the basis for the Director's allegation of “excess” cost. From this landed cost the Director deducted his version of U.S. exchange, pipeline and tanker freight to arrive at the implicit FOB price attributed to Texaco Canada's purchases of crude oil.

Table 12, following, presents the data averaged for the period 1962 through 1970, and illustrates the results of the Director's calculations.

TABLE 12

Comparison of Texaco Canada's ACTUAL or DERIVED FOB Prices of Crude Oil with Director's IMPLICIT Prices During the Period 1962 to 1970

	Per Barrel	
	Venezuelan FOB Purchases	Arabian CIF Purchases
Director's Calculation of Implicit Prices		
Landed Cost, Montreal, \$ Can.	\$2.76	\$2.68
Less: \$U.S. Exchange .....	.19	.18
Landed Cost, Montreal, \$U.S.	2.57	2.50
Less: Pipeline Freight. ....	.11	.11
Landed Cost, Portland	2.46	2.39
Less: Tanker Freight. ....	.16	—
Director's Implicit Prices	2.30	2.39
Texaco Canada's Actual or Derived FOB Prices		
Actual Price Paid (FOB)	2.19	—
Estimated Price Paid (Derived from CIF)	—	2.37
Unaccounted Difference .....	.11	.02
Percent.	4.8%	0.8%

(v) Analysis of Transportation Agreements and Costs

Texaco Canada used three strategies of securing delivery of its imported crude oil supplies from the late 1940's through the early 1970's:

- It entered into agreements with non-affiliated tanker companies for long-term, time-charters of specific vessels assigned solely to Texaco Canada and for long-term contracts of affreightment in which a specific volume of crude oil was to be moved in vessels selected by the ship owners.
- It entered into contracts of affreightment with affiliated companies to whom some of Texaco Canada's chartered vessels were assigned under certain conditions and at certain times.
- It negotiated agreements with its crude oil supplier in which the cost of transportation was included in the delivered price at destination.

Texaco Canada did not wish to enter into long-term agreements to charter its own vessels or obtain contracts of affreightment for the movement of crude oil from the Middle East, since it believed that it would be more efficient if it had access to the large scale vessels included in its crude oil suppliers' fleet. The cost of moving crude oil from the Middle East became and remained a part of the CIF price throughout the years at the request of Texaco Canada.

The company elected to make its own arrangements for ocean tankers to move crude oil from South America. At first, this crude oil went only to the Montreal refinery. When the Port Credit and the Halifax refineries were added to the company's eastern Canadian capacity, South American crude oil moved to those facilities as well.

Texaco Canada's cost of transportation of crude oil from South America in the late 1950's and most of the 1960's reflected the chartering of relatively small vessels on a long-term basis or

in contracts of affreightment which were similar in nature. The system did not enable the company to achieve the lower freight costs possible when chartering large capacity vessels.

In the early 1950's, the company was using three vessels of some 16,000 to 18,000 deadweight tons. These tankers had an average carrying capacity of 120,000 barrels, requiring about 15-17 days to make the round trip from Puerto la Cruz to Portland and back at a cost of about 40 cents per barrel carried.

By the early 1960's, other tankers of greater speed and larger capacity could have been obtained at more favourable rates. Transportation costs of 25 cents per barrel carried could have been achieved.

By the late 1960's, further improvements in tankers and the greater depth of water at the ports of discharge resulted in transportation costs of 20 cents or less per barrel for Venezuelan crude oil. Texaco Canada was finally able to avail itself of these more favourable rates as the last of the obligations which it had assumed many years before were eliminated from the transportation system.

During the period 1958-1973, Texaco Canada's transportation rates per barrel to move Venezuelan crude oil to Portland compared to the AFRA rates generally accepted as the world's standard were as follows, in Table 13.

TABLE 13
Cost of Transportation of 30° API Crude Oil to Portland, Maine
from Venezuelan Ports Used by Texaco Canada Compared to
Corresponding AFRA Rates and Rates Used by the Director
\$U.S. Per BBL.

	Paid by Texaco Canada Mata 30°	Corresponding AFRA Rate Note (1)	Director's Estimate Table A-5 (III p. 134) Note (2)
1958.....	0.26	0.46	
59.....	.29	.38	
60.....	.35	.33	0.18
61.....	.31	.31	.18
62.....	.33	.28	.18
63.....	.26	.25	.18
64.....	.24	.23	.16
65.....	.26	.20	.16
66.....	.21	.19	.15
67.....	.21	.22	.15
68.....	.21	.22	.15
69.....	.19	.19	.15
70.....		.25	.15
71.....		.29	.16
72.....		.25	.17
73.....		.36	.19

Note:

- (1) The gravity of the crude oil, port of loading and maximum size of vessel are reflected in the corresponding AFRA rates.
- (2) Rounded to nearest cent.

PART III

RESPONSE TO SOME MISCONCEPTIONS IN THE GREEN BOOKS

A. The Myth of “Harmonization”

(i) *Response to the Director’s Theory of “Harmonization”*

Alleged tacit arrangements

The essence of the Director’s allegation in Volume III is that “performance of the Eastern Canadian market was adversely affected by the transfer pricing policy of the multinationals operating in this market.”⁷⁷ The Director claims that these prices were “high compared to arm’s-length crude prices” and that these high transfer prices increased the cost of petroleum products to supracompetitive levels, because the majors “harmonized” their transfer pricing policies.⁷⁸

The Director asserts that this harmonization occurred by two means. First, in the early period of the study the majors “link[ed] their subsidiaries’ prices to the posted prices of each other at the production level.”⁷⁹ Each supply contract between parent and subsidiary “determined that the transfer price to the subsidiary would be set by reference to the posted price of a single or a group of ‘sister’ companies,”⁸⁰ with the result that “Shell was connected to Gulf; Gulf and Texaco to Exxon; and of course, Imperial received its crude from Exxon.”⁸¹

Second, when world posted prices became “increasingly unrepresentative of world prices,” a “leadership model emerged that helped the majors hold crude prices above arm’s-length world prices during this latter period.”⁸² Under this model, the “leading firm recognized that other firms tended to follow it and adopted a strategy that served to prevent the average price level for crude imports from falling to third-party levels.”⁸³ This leadership method of harmonization was buttressed by “direct inter-firm communications in order to affirm the prices that were being charged each of the Canadian subsidiaries.”⁸⁴

The Director claims that these two methods of harmonization represented the manner in which the majors sought to maximize profits.⁸⁵ He asserts that “[i]n the absence of an explicit agreement as to the price level, oligopoly managers must pursue tacit arrangements by price and output decisions that can be understood easily and that are least likely to invite disequilibrating retaliatory action.”⁸⁶ The two methods were chosen, therefore, “because they offered an efficient method of behaving predictably in pursuit of joint maximization and of reducing the likelihood of retaliation.”⁸⁷

The Director ignores the fact that the majors always faced unique, complex and constantly varying cost structures because they each used different types of crude oil in various quantities coming from divergent foreign sources. The varying cost structures gave the majors quite divergent interests. Reconciling these, and thereby setting a common (and supposedly inflated) price for crude oil delivered to Eastern Canada by “contractual parallelism” or “price leadership” or any other “implicit arrangement” would have been a practical impossibility. Moreover, documents used by the Director in the Green Books refute the Director’s allegation of “harmonization,” for they indicate that the majors’ knowledge of their competitors’ crude oil costs was limited only to supposition.

Alleged oligopolistic coordination

Profit maximization among members of an oligopoly depends upon, among other factors, coordination of the participants' price and output decisions. Only through such coordination can members of an oligopoly avoid an outbreak of competition and thereby maintain price above the competitive level.

Some have argued that when the sellers in a market are few and the products are standardized, agreement on the common profit-maximizing price is possible without formal collusion between the sellers.⁸⁸ However, when the sellers incur different costs in making their products, they will rationally desire to sell their goods at different prices.⁸⁹ To maintain a single price, or, in other words, to eliminate competition, these differences must be resolved.⁹⁰

Some commentators have argued that resolution of these differences can be accomplished in certain limited circumstances by methods of coordination such as price leadership, rule-of-thumb pricing and the like.⁹¹ However, each method suffers from the same fallibility: the more divergent the costs between the firms attempting coordination, the more complicated becomes their task of coordinating their joint pricing decisions.⁹² Moreover, the more divergent the costs, the greater will be the number of pricing decisions, and, as a result, the more thorough must be the exchange of information necessary for coordination.⁹³

In the Green Books, the Director fails to come to grips with these difficulties of coordination. He avoids the problem by ignoring divergent costs of competitors both downstream and upstream. Although he claims that oligopolistic profits for the sale of petroleum products were gained at the expense of the Canadian consumer, he does not explain how product prices could be coordinated despite divergent costs.

The Director ignores, when it suits his argument, the fact that different refiners paid different prices for crude oils acquired abroad.

The Director postulates harmony without analyzing the virtual impossibility of accomplishing that result.

First, to ensure that their refineries bought crude oil at equal average cost, multi-national exporters would have had to assign an appropriate value for each crude oil used by their Canadian refineries. The complexity of this task, absolutely overlooked by the Director, cannot be overstated. Because crude oils are distinguishable by reason of their differing qualities, which include factors such as sulphur content and gravity, they produce varying amounts of refined products at varying refining costs.⁹⁴ Further, crude oils cost different amounts because of factors such as cost of production and geographic proximity to refineries.⁹⁵ Indeed, the evidence has been that the same crude oils can have different realizable values in different refineries.

Second, taking into account the relative values assigned to crude oils, multi-national exporters would have had to derive a transfer price structure which would have equalized the average crude oil cost to their refineries.⁹⁶ This task would have by necessity involved an enormous exchange of information. Not only would it have been necessary for exporters to have known the different crude oil slates used by each firm's refineries, they would also needed to have known the refineries' varying yield structures. Because refineries have different capabilities, they produce different yields from the same crude oil slate.⁹⁷ Therefore, the cost of producing the same quantity of product differs between the refiners. Stated differently, the value of the same crude oil — its economic cost to a refiner — differs among refiners. As a result, Canadian

refineries could have equalized the costs of their crude oil — their input costs — only by exchanging information concerning both their refineries' slates and resultant yields.

In view of the complex nature of the transfer pricing decisions that would have faced the Canadian refiners to accomplish coordination of their crude oil input costs — complexity created by the necessity to assign relative values to different crude oils and the need to average their crude oil costs — it is ironic that the Director claims that coordination was possible by tacit collusion such as “contractual parallelism” or “price leadership.” Coordination of crude oil costs could simply not have occurred without hard bargaining and the exchange of an immense amount of information. Indeed, even if such conduct had occurred, coordination might not have been successful. Even the most explicit, open cartel possible — OPEC — has had difficulty, and at times has failed, to accomplish only the first task, valuing diverse crude oils, which would have been necessary for the coordination alleged by the Director. These pricing decisions would have been most difficult to resolve even by explicit agreement and coordination. Resolution by tacit collusion would have been impossible.

(ii) Response to Specific Allegations of “Harmonization”

The Director alleges, at page 17 and following, that the parents of the four major Canadian companies tied the prices paid by those subsidiaries for crude oil to one another over a significant time span during the 1950's and 1960's and into the 1970's.

The Director reports, at pages 18-19, that in 1956 Texaco Inc. tied the price paid by Texaco Canada for Venezuelan crude oil to the average of postings by Creole and Mobil in Venezuela. The Director also notes that Texaco Canada's Middle East crude oil price changes were also tied to changes in the Venezuelan postings. It is reported that this practice of tying crude oil price changes to Venezuelan postings continued into the 1960's.

Contrary to the Director's allegations, these price adjustment clauses were a normal business arrangement and, in fact, resulted in significant financial benefit to Texaco Canada.

Adjustment clauses are necessary and quite common in that they provide protection to both parties if changes occur in supply or demand. With specific reference to Texaco Canada's supply contracts, it made good business sense to tie any adjustment of prices to a major field in Venezuela that was active during the term of the contract. Crude oil produced from such a field cannot be priced arbitrarily as it enters too many markets. In Venezuela, the Oficina field was producing over 56,000 barrels per day in 1956 and by that year, had produced a total of 256,000,000 barrels. In 1960, the Venezuelan Tia Juana field was producing 174,000 barrels per day and had produced a total of 1,395,000,000 barrels. Accordingly, Texaco Canada considered postings in respect of these crude oils to be good references for price adjustment clauses in their contracts for both Venezuelan and Arabian crude oils in the respective years.

As well, far from being disadvantageous to Texaco Canada, this tying scheme was of significant financial benefit. As Venezuelan crude oil prices fell in the 1960's prices for Middle Eastern crude oils did not follow them down. However, since the contract which Texaco Canada had with its parent for the supply of its Middle Eastern requirements incorporated this tying clause, the prices which Texaco Canada paid for Middle eastern crude oil were substantially lower during this period than if the tying clause had not been incorporated into its supply contract. It was thus to Texaco Canada's advantage to have its Middle Eastern crude oil prices tied to Venezuelan postings.

The Director alleges that the company reported its competitors' crude oil costs to its parent. The two examples given are some seven years apart in time, and reflect only the understanding of Texaco Canada's negotiator in his attempt to obtain the best possible price for crude oil from his supplier. The negotiator obtained his information from sources as varied as Platt's Oilgram, published posted prices and freight prices, and even his personal interpretation of declarations by spokesmen at Imperial Oil press conferences. Not surprisingly, much of this information was not reliable. As the quoted documents themselves reflect, much was impression and belief on the part of the negotiator.

In his conclusion to this section, the Director asserts that the four Canadian majors all paid unrealistically high crude oil prices and were able to pass along their high costs in varying degrees to product markets. The fallacy contained in this conclusion is that the Director omits to consider the competitive forces found in the wholesale and retail marketplace. It appears simplistic to assert, but it would seem necessary to do so, that the prices found in the marketplace are far more the product of competition than they are of costs of supply or of manufacture encountered by any particular seller.

Texaco Canada sold and still sells its products both at retail and wholesale in a competitive marketplace where many sellers are found and where more than just the four majors compete. In order to keep its customers, or share of market as the case may be, Texaco Canada must take into consideration far more factors than simply its crude oil costs.

It is also important to remember that throughout this period, the import option was present. Even the Green Books acknowledge that this option had a restraining impact on product prices in Canada. To assert, therefore, that Texaco Canada was able to pass on unreasonably high costs in the marketplace reflects a lack of understanding of the competitive market.

In an industry of such complexity and of such widely diversified interests, goals and objectives, technical and financial resources it would be virtually impossible to exercise the degree of co-ordination, co-operation and unity of purpose that would be required to accomplish the concerted action which the Director alleges to have existed.

The petroleum industry in Canada is an entity in name only. There are many companies engaged in the business and each has different goals tied together only by the single thread of a basic commodity — petroleum.

There is no concerted action. There is vigorous competition at all levels, from the bidding for oil and gas exploration rights through all of the transportation, processing and distribution activities to the acquisition of permits for the erection of retail marketing outlets by which most companies present their corporate image to the public.

B. Other Matters Relating to the Company's Operations

(i) Negotiations or Agreements to Process Crude Oil by or for Sun, Petrofina and Golden Eagle

At pages 60-61 of Volume III, the Director alleges that processing agreements were a vehicle through which "the parent corporation was able to coordinate the behaviour of Texaco [Canada] with subsidiaries of other major oil companies operating in Canada".

The Director refers to negotiations for processing which took place between Texaco Canada and three other refiners — Sun, Petrofina and Golden Eagle.

This allegation demonstrates a misunderstanding by the Director of the purpose and operation of a processing arrangement.

The Director cites a Sun-Texaco processing arrangement in Montreal which allegedly facilitated the coordination, by Sun and Texaco in the United States, of the prices their Canadian subsidiaries paid for Middle Eastern crude oil.

Negotiations between Texaco Canada and Sun Oil took place as a result of the announcement of the National Oil Policy in 1961. This policy sought to reserve that portion of Ontario west of the Ottawa Valley for products made substantially from domestic crude oil. Texaco Canada expected that by 1963 it would not be able to supply all of its customers in the area since the Port Credit refinery did not have sufficient capacity.

Accordingly, the company entered into a long-term reciprocal processing agreement with Sun Oil whereby Sun would process for Texaco Canada, at its Sarnia refinery, a quantity of Canadian crude oil supplied by Texaco Canada and Texaco Canada, in turn, would process, at its Montreal refinery, a similar quantity of imported crude oil supplied by Sun.

Through this arrangement, Texaco Canada was able to supply all of its customers in Ontario and to utilize some of its Montreal refinery capacity which otherwise would have been idled under the conditions imposed by the National Oil Policy of 1961.

Texaco Canada did request Sun to supply a crude oil other than the Sassan which was offered and indicated a preference for Arabian Light crude oil. Through an exchange arrangement which was negotiated between the parent companies, Texaco Canada did obtain Arabian Light crude oil for processing on behalf of Sun. Since the crude oils were not similar in quality or processing characteristics, a refining differential was apparently agreed to by the sellers of the respective crude oils.

Texaco Canada had no need to know the price which Sun Oil paid for the crude oil which was supplied for running at its Montreal refinery, but for purposes of simplifying the accounting procedures merely assumed the landed cost to be the same as its own.

This agreement resulted in an exchange which enabled both companies to optimize refining capacity and enhance their competitive position.

Also referred to by the Director is a situation, in 1970, in which it is alleged that “the parent firm urged Texaco [Canada] to reach a processing agreement with Petrofina in Montreal (Document #53907)”.⁹⁸ While the Director concedes that this arrangement was “apparently” not implemented, he goes on to speculate that “it would have served to draw one of the smaller refiners in the Quebec market more closely into the fold of the leading firms”.⁹⁹

In the early 1970’s, Texaco Canada’s forecasts of product demand indicated a need for more refining capacity in Quebec than was available from its Montreal refinery. In the pre-OPEC days, the growth of the economy and of petroleum demand in Canada was strong. There appeared to be no end to the continued upward pressure on product demand and Texaco Canada was examining the alternatives which it had in deciding upon the course of future supply.

Since the company was close to a decision with respect to the building of a totally new refinery in Ontario, it was not anxious to commit any substantial amount of capital to a simultaneous expansion of its Montreal refinery.

Accordingly, the strategy which the company adopted was to seek to use such spare refining capacity as might be found in Quebec.

Negotiations with Petrofina to process crude oil for Texaco Canada at its Montreal refinery were unsuccessful — the two companies simply could not agree upon the commercial terms. The Director's suggestion that the parent firm "urged" Texaco Canada to conclude an agreement because it could then sell the crude oil to Petrofina is a misunderstanding of the way in which such processing agreements work. The crude oil would have been supplied by Texaco Canada to any company which would have entered into an agreement to process such crude oil. The question of "selling" the crude oil to the processor was not the way in which such arrangements generally were concluded.

Such was also the situation in respect of the final example used by the Director — a processing arrangement between Texaco Canada and Golden Eagle, entered into at about the same time as the unconsummated Petrofina-Texaco Canada agreement. The Director alleges that "... the manner in which [the Golden Eagle arrangement] was effected indicates that it was the parent who organized the arrangement and the Canadian subsidiary was left with little choice but to participate.", even though Texaco Canada was allegedly "... unhappy with the basis on which it was told to participate . . .".¹⁰⁰ The Director asserts that by "linking the interests of two otherwise separate companies, [this incident] increased the degree of market concentration and by increasing the likelihood that crude oil transfer prices would be coordinated, it reduced the potential for competition that arises from the existence of a competitive advantage in input costs".¹⁰¹

Texaco Canada was the buyer of the crude oil. Golden Eagle was the processor — for a fee.

As part of Texaco Canada's search in the early 1970's for additional refining capacity in Quebec — without the need to invest heavily in expansion of its Montreal refinery — the company learned of the potential availability of capacity at the Golden Eagle plant at St. Romuald, Quebec when the parent company purchased the Panama refinery from Ultramar (the Golden Eagle parent) early in 1973.

Texaco Inc. was interested at that time in obtaining a source of supply for heavy fuel oil to be imported into the U.S. northeast. It inquired about the possibility of buying the Golden Eagle refinery. This was rejected by the owner, but negotiations to process crude oil for Texaco Canada in St. Romuald began.

In the last half of 1972, Texaco Canada became involved in these negotiations because of its own plans for obtaining additional supplies of gasoline, middle distillate and heavy fuel oil, particularly the latter, for which demand was expected to continue to grow strongly in Quebec.

The agreement, which involved both parent and subsidiary companies, was a commercial arrangement which went into effect on July 1, 1973 and was expected to terminate in 1981 upon completion of the processing of 49 million barrels to be supplied by Texaco Canada to the Golden Eagle refinery in St. Romuald.

The agreement was not a particularly successful venture for the Texaco organization in the long run. The OPEC crisis of 1973 altered fundamentally the course of petroleum use in Canada, and the forecast of demand growth upon which the whole arrangement had been predicted was not to be realized.

(ii) Significance of Assessments by the Department of National Revenue

Although no competition issue is made out, Texaco Canada hereby responds to the allegation that it evaded or attempted to evade the payment of income tax.

The evidence shows that the Taxation Division of the Department of National Revenue was generally satisfied that Texaco Canada paid fair market value for crude oil imported into Canada throughout the period 1958 through 1973.

The Department did contest the prices paid for foreign crude oil in the early 1960's. Realizing that resistance to a proposed re-assessment would entail payment of the disputed amount plus interest as well as much loss of time, inconvenience and cost before the issue would finally be determined, Texaco Canada accepted re-assessments for its fiscal years 1961 and 1962. This settlement was on the basis that its Middle East and Venezuelan crude oil purchases were deemed to have been made at posted prices in the countries of origin minus 12% thereof plus an amount for freight. The freight component employed was the relevant AFRA rate for crude oil transported by non arms-length carriers and actual freight charged by third party carriers. It was agreed that there would be no re-assessments for the fiscal years 1963, 1964 and 1965 with respect to foreign crude oil purchases, as the actual cost of such purchases in each of those years was less than the values computed in the matter set out above with respect to 1961 and 1962. There was an adjustment made for the 1963 taxation year in order to bring the amount of the opening inventory of foreign crude oil into agreement with the amount of the closing inventory allowed for the 1962 taxation year.

The dollar amount of the re-assessment by the Department of National Revenue is insignificant when compared to the total price paid by Texaco Canada for imported crude oil (see Table 14, following) and the company's taxable income throughout the period under review. In fact, the reduction in imported crude oil costs as a result of re-assessments during the period 1958 to 1973 amounts to slightly more than one-tenth of one percent of the company's total cost of imported crude oil over the same period. Similarly, the increase in Texaco Canada's taxable income due to re-assessments relating to crude oil prices represents less than half of one percent of the total of taxable incomes reported for the years 1958 to 1973.

TABLE 14
Reduction in Imported Crude Oil Costs Per DNR Assessments
Compared to Total Cost of Imported Crude Oil
1958-1973

<u>Year</u>	<u>Reduction in Imported Crude Oil Costs Per DNR Assessments</u> (millions)	<u>Total Cost of Imported Crude Oil</u> (millions)
1958.....	—	\$ 59
1959.....	—	61
1960.....	—	61
1961.....	\$1.0	59
1962.....	0.3	53
1963.....	—	51
1964.....	—	47
1965.....	—	45
1966.....	—	49
1967.....	—	49
1968.....	—	60
1969.....	—	58
1970.....	—	63
1971.....	—	73
1972.....	—	84
1973.....	—	116
Totals.....	<u>\$1.3</u>	<u>\$988</u>

Auditors from the Department of National Revenue, Taxation Division continued to examine Texaco Canada's crude oil contracts and costs in subsequent years, up to and including 1976, and have never re-assessed or suggested any revision to Texaco Canada's crude oil purchases in any of those years. Those auditors are now engaged in an examination of Texaco Canada's crude oil purchases in respect of the years 1977 and 1978.

It is Texaco Canada's submission that the absence of any significant challenge by the Department of National Revenue with respect to prices paid by the company for imported crude oil refutes the Director's allegation that Texaco Canada paid excessively high prices for imported crude oil throughout the period 1958 through 1973.

PART IV

CRUDE OIL ACQUISITION TODAY

In this phase of the Inquiry there is now only a single relevant point: the producing nations generally control the price of crude oil moving in the international market. As the Department of Energy, Mines and Resources explained, by “the mid-1970’s the large multi-national oil companies had lost their dominance over world oil production, and a new force emerged: The Organization of Petroleum Exporting Countries (OPEC), a cartel formed to obtain higher returns for its oil through supply management and decree.”¹⁰² Because the producing countries have “seized three vital areas of control,” power over price, production, and distribution,¹⁰³ they determine the prices for crude oils imported by Canadian refineries.

This conclusion is demonstrated by evidence already before this Commission. Messrs. Kealy, Priddle, Dean and Bechtold have testified that crude oil must now be purchased at official selling prices determined by producing nations.¹⁰⁴

In addition, a significant portion of the crude oil imported into Canada must be purchased from the producing countries directly by importing refiners because the producing nations now refuse to deal with buyers other than end-users. Thus, Texaco Canada and all other importers of Venezuelan crude oil may only purchase Venezuelan production directly from the Venezuelan government oil company.¹⁰⁵ Further, “virtually all” of the Mexican crude oil acquired by Canadian refiners is purchased under the terms of the government-to-government agreement with Mexico under which Petro-Canada acts as Canada’s agent.¹⁰⁶ Indeed, at least one-half of the crude oil now entering Canada moves through non-affiliated channels and thus is never subject to a transfer price at all.¹⁰⁷ As a matter of simple logic, this oil cannot be imported under the excessive transfer prices alleged by the Director.

Moreover, in view of the control over price exercised by most producing countries, including Canada, it should not be said that a parent company controls the price of crude oil sold to its subsidiary simply because that subsidiary buys some of its imported oil through an affiliated channel. Indeed, Mr. Kealey’s important evidence that he could “not recall a company having paid in excess of the official selling price”¹⁰⁸ can be explained by simple economics. Because Canadian imports are now dominated by crude oil moving through non-affiliated channels, and because any importer can increase its output by purchasing crude oil at official selling prices, no parent can charge its subsidiary prices higher than official selling prices without raising the subsidiary’s costs above those of its competitors, and without thereby placing the subsidiary in an untenable economic position. Thus, crude oil moving through both affiliated and non-affiliated channels must reflect the price control exercised by the producing countries. The Director’s international recommendations, which are aimed at pricing powers that the multi-national majors do not possess, must, therefore, be rejected.

EXHIBIT 1
Texaco Canada
Analysis of Director's Table 13
"Market Strength"

	<u>1970</u>	<u>Jan. 1971</u>	<u>July 1972</u>	<u>Jan. 1973</u>	<u>1973 vs. 1970</u>
LAGOMEDIO 32°					
FOB Price	1.99	2.12	2.65	2.735	.745
Freight	<u>.25</u>	<u>.33</u>	<u>.24</u>	<u>.27</u>	<u>.02</u>
	2.24	2.45	2.89	3.005	.765
Transit Loss	<u>.01</u>	<u>.01</u>	<u>.01</u>	<u>.01</u>	—
CIF Price	2.25	2.46	2.90	3.015	.765
Director's HGT . . .	<u>2.25</u>	<u>2.38</u>	<u>2.87</u>	<u>2.99</u>	<u>.74</u>
Texcan . . . . .		.08	.03	.025	.025
Freight		<u>.08</u>	<u>(.01)</u>	<u>.02</u>	<u>.02</u>
Net		0	.04	.005	.005
ARABIAN 34°					
FOB Price	1.20	1.24	1.86	1.915	.715
Freight	<u>1.07</u>	<u>1.44</u>	<u>1.03</u>	<u>1.15</u>	<u>.08</u>
	2.27	2.68	2.89	3.065	.795
Transit Loss	<u>.01</u>	<u>.01</u>	<u>.01</u>	<u>.01</u>	—
CIF Price	2.28	2.69	2.90	3.075	.795
Director's HGT . . .	<u>2.28</u>	<u>2.35</u>	<u>2.80</u>	<u>2.97</u>	<u>.69</u>
Texcan . . . . .		.34	.10	.105	.105
Freight		<u>.37</u>	<u>(.04)</u>	<u>.08</u>	<u>.08</u>
Net		(.03)	.14	.025	.025

EXHIBIT 2

Landed Cost of Arabian Light Crude Oil (34° API) at Montreal and Portland Adjusted for °API Gravity, Pipeline Losses, U.S. Dollar Exchange Rates and Other Items Not Available to the Director from Data Supplied at the Toronto Hearings

\$U.S. per Barrel

Year	Landed Cost at Montreal as used in Director's Table B-1 (1) & (2)	Adjustments				Landed Cost at Montreal Re-Stated	Less: Pipeline Tariff	CIF Portland
		°API Gravity	Pipeline Losses (3)	\$U.S. Exchange Rate	Other Items			
1958.....	3.12		(.01)			3.11	0.11	3.00
59.....	2.94		(.01)		(.01)	2.92	.11	2.81
60.....	2.84		(.01)	(.03)	(.01)	2.79	.11	2.68
61.....	2.78		(.01)	(.05)	(.02)	2.70	.11	2.59
62.....	2.68		(.01)	(.03)	(.02)	2.62	.11	2.51
63.....	2.57				(.02)	2.55	.12	2.43
64.....	2.58			(.01)	(.02)	2.55	.12	2.43
65.....	2.48	(.02)			(.01)	2.45	.12	2.33
66.....	2.47			(.01)	(.02)	2.44	.11	2.33
67.....	2.46				(.02)	2.44	.11	2.33
68.....	2.43					2.43	.10	2.33
69.....	2.44				(.01)	2.43	.10	2.33
70.....	2.34			.04		2.38	.10	2.28
71.....	3.03				(.01)	3.02	.11	2.91
72.....	3.05				(.01)	3.04	.11	2.93
73.....	3.57				(.19)	3.38	.11	3.27

Note:

- (1) For 1968 the data supplied on Exhibit No. T-17 of the Toronto Hearings contained a typographical error in the cost of Arabian crude oil landed at Montreal. The reported cost of \$2.67 Canadian funds should have read \$2.62. The conversion of this to U.S. funds reduced the cost from \$2.48 as used by the Director to \$2.43 as shown above.
- (2) For 1973, the Director's table contained a typographical error. The landed cost was \$3.57 in Canadian funds as reported on Exhibit No. T-17 of the Toronto Hearings, or \$3.57 in U.S. funds with the currency being at par in that year. This was the average for the year including one million barrels delivered directly to St. Romuald, Quebec during the second half of the year for processing on behalf of Texaco Canada. The contract price for deliveries to St. Romuald was higher than to Montreal via Portland because of draft limitations.
- (3) A pipeline transit loss of ½ of 1% was charged by the Portland-Montreal Pipeline system 1958-1962 inclusive.

EXHIBIT 3

Landed Cost of Venezuelan (Mata) 30° Crude Oil at Montreal and Portland Adjusted for °API Gravity, Pipeline Losses, U.S. Dollar Exchange Rates and Other Items Not Available to the Director from Data Supplied at the Toronto Hearings

\$U.S. per Barrel

Year	Landed Cost at Montreal as used in Director's Table B-1 (1) & (2)	Adjustments				Landed Cost at Montreal Re-Stated	Less: Pipeline Tariff	Cost at Portland
		°API Gravity	Pipeline Losses (3)	\$U.S. Exchange Rate	Other Items (4)			
1958.....	3.31	(.08)	(.01)		(.01)	3.21	0.11	3.10
59.....	3.08		(.01)		(.03)	3.04	.11	2.93
60.....	2.93		(.01)		(.02)	2.90	.11	2.79
61.....	2.95		(.01)	(.05)	(.03)	2.86	.11	2.75
62.....	2.86		(.01)		(.02)	2.83	.11	2.72
63.....	2.67					2.67	.12	2.55
64.....	2.63				(.04)	2.59	.12	2.47
65.....	2.57					2.57	.12	2.45
66.....	2.54	(.02)			(.01)	2.51	.11	2.40
67.....	2.57	(.04)			(.02)	2.51	.11	2.40
68.....	2.53	(.04)			.01	2.50	.10	2.40
69.....	2.51	(.04)			.01	2.48	.10	2.38
70.....	2.29			.02		2.31	.10	2.21
71.....	2.85	(.03)			.01	2.83	.11	2.72
72.....	2.94	(.03)			.17	3.08	.11	2.97
73.....	6.16	(.03)			(1.76)	4.37	.11	4.26

Note:

- (1) In 1972, the Director used the landed cost of Mata (30°) at Halifax since there were no receipts of this grade at Montreal. The adjusted figure of \$3.08 represents the average for the year of Lagomedio crude oil at 30° API equivalent.
- (2) In 1973, the Director again used the landed cost of Mata (30°) at Halifax because Montreal did not receive this kind of crude oil. The receipts at Halifax consisted of two cargoes obtained during the last quarter of the year at prices which reflected sharply increased Host Government Take. The adjusted figure of \$4.37 represents the average for the year of Lagomedio crude oil at 30° API equivalent.
- (3) A pipeline transit loss of ½ of 1% was charged by the Portland-Montreal Pipeline system 1958-1962 inclusive.
- (4) In 1964, the company received a mid-year adjustment to its Venezuelan crude oil contract. This adjustment, made in a letter of agreement dated May 28, 1964, reduced the price of all Venezuelan crude oil purchased during the year by 6 cents per barrel U.S. funds.

NOTES

1. "Estimated Demand for Petroleum Products" as prepared by Texaco Canada, primarily from Statistics Canada, *Refined Petroleum Products* (Cat. No. 45-004). See Tab 1, Volume C.
2. See Table 1, p. 11.
3. Dominion Bureau of Statistics, *The Crude Petroleum Industry in Canada, 1946*, at p. 1 (now Statistics Canada Cat. No. 26-213). See Tab 2, Volume C.
4. Dominion Bureau of Statistics, *Petroleum Products Industry, 1946*, at pp. 19-20. (now Statistics Canada Cat. No. 45-205). See Tab 3, Volume C.
5. See Tab 3, Volume C, at p. 7.
6. See note 1, above.
7. *The Petroleum Data Book* (1947 edition), at p. F-86. See also United States Department of Energy, *Trends in Motor Gasolines: 1942-1981*, at pp. 7-8. (Cat. No. DOE/BETC/RI-82/4).
8. See note 1, above.
9. Dominion Bureau of Statistics, *The Natural Gas Industry in Canada, 1946*, at p. 1. (now Statistics Canada Cat. No. 26-213). See Tab 4, Volume C. See also Tabs 2 and 3, Volume C.
10. See note 1, above.
11. *Canadian Petroleum Association Statistical Handbook*.
12. *Idem*.
13. *Idem*.
14. *Idem*.
15. Energy, Mines and Resources, *Petroleum Refineries in Canada*. 1981 capacities estimated by Texaco Canada.
16. Statistics Canada, *Refined Petroleum Products* (Cat. No. 45-004).
17. Statistics Canada, *Oil Pipe Line Transport* (Cat. No. 55-201). Predecessor reports were titled *Pipe Line (Oil) Statistics*.
18. See note 1, above.
19. See note 7, above.
20. Statistics Canada, *Road Motor Vehicles Registrations* (Cat. No. 53-219).
21. Statistics Canada, *1976 Census of Canada, Special Series — Agriculture* (Cat. No. 96-853).
22. See note 1, above.
23. *Idem*.
24. See note 11, above.
25. *Idem*.
26. *Idem*.
27. *Idem*.

28. See note 15, above.
29. See note 16, above.
30. See note 17, above.
31. See note 1, above.
32. See note 7, above.
33. See note 20, above.
34. See note 21, above.
35. See note 1, above.
36. Chase Manhattan Bank, *Capital Investments of the World Petroleum Industry*, Annual Reports and Historical Summary 1946-1981.
37. See note 1, above.
38. See note 11, above.
39. *Idem.*
40. *Idem.*
41. *Idem.*
42. See note 15, above.
43. See note 16, above.
44. See note 17, above.
45. See note 1, above.
46. See note 20, above.
47. See note 21, above.
48. See note 1, above.
49. See Tab 5, Volume C.
50. *International Petroleum Encyclopedia*, Volume 14, pp. 306 and 324.
51. See Tab 6, Volume C.
52. See Tab 7, Volume C.
53. See Tab 8, Volume C.
54. See Tab 9, Volume C.
55. See Tab 10, Volume C.
56. See Tab 11, Volume C.
57. See Tab 12, Volume C.
58. See Tab 13, Volume C.
59. *Idem.*
60. See Tab 14, Volume C.
61. *Idem.*
62. *Idem.*

63. *Idem.*
64. See Tab 15, Volume C.
65. See Tab 14, Volume C.
66. *Idem.*
67. *Idem.*
68. See Tab 16, Volume C.
69. See Tab 17, Volume C.
70. See Tab 8, Volume C.
71. See Tab 18, Volume C.
72. See Tab 19, Volume C.
73. See Tab 8, Volume C.
74. See Tab 20, Volume C.
75. See Tab 21, Volume C.
76. See Tab 22, Volume C.
77. Green Books, Volume III, at p. 1.
78. *Op. Cit.*, at p. 1.
79. *Op. Cit.*, at p. 17.
80. *Op. Cit.*, at p. 20.
81. *Idem.*
82. *Op. Cit.*, at p. 21.
83. *Idem.* In fact, however, Imperial Oil Limited has demonstrated that its prices for imports fell within the range of comparable arm's-length transactions. See the Second Submission of Imperial Oil Limited to the Restrictive Trade Practices Commission, Volume A, at pp. IX-1 to IX-24.
84. Green Books, Volume III, at p. 21.
85. See, e.g., *Op. Cit.*, at p. 13.
86. *Idem.*
87. *Idem.*
88. See, e.g., F. Scherer, *Industrial Market Structure and Economic Performance*, (2d ed. 1980) at p. 156 [hereinafter cited as *Scherer*].
89. See, e.g., *Idem.* In the words of economists, the firms will have different marginal cost curves, which will, as a result, intersect the marginal revenue curve faced by all at different points. Consequently, each firm will perceive a different profit-maximizing price.
90. For simplicity of analysis, we focus only on the different costs to the majors. Other factors also creating antagonistic interests — such as different market shares, resulting in different perceptions of market demand, see, e.g., *Op. Cit.*, at p. 158 — will be ignored.
91. See generally *Scherer*, at pp. 176-197.
92. See *Scherer*, at pp. 156-160, 176, 180, 185, 189, 205-212.

93. See, e.g., *Scherer*, at pp. 202-203.
94. See, e.g., the Second Submission of Imperial Oil Limited to the Restrictive Trade Practices Commission, Volume A, at pp. V-6, VII-4 to VII-5.
95. See *Op. Cit.*, at pp. V-2 to V-3, V-5.
96. Indeed, the task would have been even more complicated. In discussing “harmonization” of crude oil costs, the Director would have the reader believe that Eastern Canada comprised one market in which refined products compete. On the contrary, refineries compete on a regional basis. Therefore, equalization of crude oil costs to facilitate an oligopoly’s coordination of product prices would have had to have been accomplished within each geographic market in Eastern Canada.
97. For example, two of Texaco Canada’s refineries have produced the following yields, expressed in percentages, from an identical crude oil slate:

<u>Product</u>	<u>Refinery A</u>	<u>Refinery B</u>
Gasoline	34.8	31.8
Stove Oil.....	7.9	7.2
Diesel	15.2	13.9
Furnace Fuel Oil.....	16.1	14.7
Residual Fuel Oil	20.5	26.1
Total Clean	74.0	67.6
Propane	0.6	—
Butane	—	1.2
Liquid Recovery	95.1	94.9

Source: Texaco Canada Processing and Planning Division Study, 1982.

98. See Tab 20, Volume C.
99. Green Books, Volume III, at p. 61.
100. *Idem.*
101. *Idem.*
102. Energy, Mines and Resources Canada, *The National Energy Program* (1980), at p. 3.
103. *Op. Cit.*, at p. 4. See also the Second Submission of Imperial Oil Limited to the Restrictive Trade Practices Commission, Volume A, at pp. III-6 to III-15.
104. See Transcript, Vol. 42 at pp. 8619, 8620, 8675 (Kealey and Priddle); Transcript, Vol. 43 at pp. 8797-98, 8845-46, 8882-83, 8912, 8932-33 (Dean and Bechtold); Transcript Vol. 44 at pp. 8961, 8963, 8984-86, 9024 (Kealey and Priddle); Transcript, Vol. 43 at pp. 8794-95, 8809, 8840-41 (Dean and Bechtold).
105. See Transcript, Vol. 43 at pp. 8793-94 (Dean and Bechtold).
106. See Transcript, Vol. 42 at p. 8709 (Priddle).
107. See, e.g., Transcript, Vol. 42 at p. 8710 (Kealey).
108. Transcript, Vol. 43 at p. 8963.

